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COST REDUCTION FOR DEFENSE

ABSTRACT

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This thesis discusses cost reduction as an aid to financial management and its implementation into the Department of Defense to reduce the cost of national security. The study is concerned with the steps required to implement a cost reduction program rather than defining specific savings.

A basis for implementation is developed by summarizing the principles commonly found in any cost reduction program. The implementation of cost reduction into the Department of Defense and the Navy is then documented along historical lines and compared to the basic principles. Problem areas in defense cost reduction are analyzed.

The Department of Defense Cost Reduction Program has developed into a formal five year program with the objectives of reducing procurement and logistics costs by \$4 billion per year through improved management practices. Program achievements have impressed Congress and surpassed initial goals. The Cost Reduction Program is well established in the Department of Defense and seems to be expanding.

COST REDUCTION FOR DEFENSE

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A thesis submitted to the faculty of the School of Government,
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COST REDUCTION FOR DEFENSE

INTRODUCTION

While it is vital for us to maintain a military force structure that will insure our security and sustain our foreign policy commitments it is also vital to our economic health that we operate this force at the lowest cost possible.¹

This statement not only explains President Kennedy's basic philosophy on national defense but reflects the concern of government, business and the individual American citizen for the cost of defense. Economy in government activities has become a popular issue. Indeed the first message of President Johnson to Congress after assuming office in November 1963 highlighted economy.

...I pledge that the expenditures of your government will be administered with the utmost thrift and frugality. I will insist that the government get a dollar's value for a dollar spent.²

Of all the United States Government activities, the Department of Defense represents the largest agency.

¹President John F. Kennedy, "The Department of Defense Cost Reduction Program," news release, July 6, 1962, p. 1.

²U.S., Congress, House, Message to the Congress, Address of the President of the United States, delivered before a Joint Session of the Senate and the House of Representatives, 88th Congress, 1st Session, November 27, 1963, p. 3.

No single private or government organization approaches it in size or expenditure of funds. There is bound to be some inefficiency in such a large complex organization.

Secretary of Defense McNamara summarized the problem of defense inefficiency in this way.

In an institution which is responsible for directing the operations of $3\frac{1}{2}$ million people, roughly 1 million civilians and 2.7 million military personnel which spends \$50 billion -- odd a year of the Nation's resources, roughly 9 percent of its [Gross National Product] GNP, and yet faces a change of management, if you will, every few years -- as a matter of fact, a change of top management in some periods in the past has occurred on the average of every 18 months -- I am sure you will recognize there are many areas of potential improvement.³

Defense is big business and the job of reducing costs in the Department of Defense is a gigantic task. The purpose of this thesis is to document the growth of the Department of Defense Cost Reduction Program and the methodology used in making the program come alive and produce results. The subject is mainly approached from the aspect of how a cost reduction program is implemented and not with the view of dissecting the specific items that produce savings. Major cost reduction areas are identified, but the main concern is with the techniques of organizing and making the program workable and effective. All military services are an integral part of the cost reduction

³U.S., Congress, House, Subcommittee of the committee on appropriations, Hearings, Department of Defense Appropriations for 1964, Part I, Secretary of Defense, 88 Congress, 1st Session, 1963, p. 242.

program but this historical presentation is slanted toward the leadership provided by the Office of the Secretary of Defense and Navy's actions in implementing the program.

There are no text books or check off lists that specify how to cut costs and how to institute a cost reduction system. What succeeds in one organization may not produce results in the next structure. However, the efforts of private enterprise to control costs have evolved around several common principles. Professional associations and management executives have recorded the fundamental elements that are considered essential to the success of any cost reduction program. These principles are leadership from the top executive, integration of cost reduction with other financial management activities, establishing specific responsibilities and goals to be achieved, making the cost reduction program a team effort, providing incentives and communications channels, and establishing a system for reporting and control. Combinations of several, sometimes all, of these interlocking principles are desirable for an effective cost reduction program.

With the election of President Kennedy and the appointment of Secretary of Defense McNamara came a new Department of Defense integrated management system. The system was based on strong central control by the Secretary. Major improvements were instituted in the planning,

programming, reporting and decision making processes. Instructions from President Kennedy and requests by Congress for economy resulted in the Secretary of Defense launching a department wide cost reduction program. This cost reduction program, started in 1961, was to concentrate on reducing costs in the area of procurement and logistics. Formal implementation of cost reduction program in the Department of Defense was not achieved until the other financial management and control systems were established.

Prior to the formal implementation of the cost reduction program there were several key events in its development. The most important developments were:

June 1961 --The National Security Industrial Association (NSIA) Symposium on cost reduction at which time the Defense Department briefed industry of the coming cost reduction efforts.

July 1962 -- The Secretary of Defense reported the proposed activities and goals of the Department of Defense Cost Reduction Program to the President.

September 1962 -- The military departments and defense agencies were requested to take immediate actions to plan and implement the cost reduction program.

A Cost Reduction Steering Committee was established in September 1962 to coordinate the program. In the ensuing months this committee, with the aid of Sub-Groups Committees,

refined cost reduction areas and divided the goals among the military departments and defense agencies. The Steering Committee worked on the basic tasks of (1) establishing the cost reduction areas and goals, (2) devising a reporting system and (3) planning a publicity-communications system.

The culmination of the initial work performed by the Steering Committee was the three instructions that formally implemented the cost reduction program in the Department of Defense. The dates and subjects of the three instructions were:

February 1, 1963 -- Department of Defense Cost Reduction Program.

March 7, 1963 -- Department of Defense Cost Reduction -- Reporting Requirements.

April 18, 1963 -- Newsworthy items for the publication, "Department of Defense Cost Reduction Program."

The Secretary of Defense presented the first annual Cost Reduction Program Report to the President outlining the program and its achievements in July 1963. Secretary McNamara described the cost reduction program to Congress as:

...a formal 5--year cost reduction program which has as its objective the reduction of procurement and logistic costs by \$4 billion per year through improved management practices. Specific quantitative cost reduction goals have been established for each of the principal areas of logistics management. Selected goals, in turn, have been established for the military departments and defense agencies (i.e., DSA AND DCA) so that our key logistics managers know exactly what is expected of them.

Cost reduction goals are:

1. Buy only what we need.
 - a. Refining the requirements calculations.
 - b. Increased use of excess inventories.
 - c. Eliminating "Goldplating" of technical specifications.
2. Buy at the lowest sound price.
 - a. Shifting from noncompetitive to competitive procurement.
 - b. Shifting from cost plus fixed fee (CPFF) to fixed price and incentive contracts.
3. Reducing operating costs.
 - a. Terminating unnecessary operations -- by closing or reducing unneeded bases and installations.
 - b. Standardizing and simplifying paperwork and procedures.
 - c. Consolidating and increasing efficiency of operations.⁴

The Navy's participation in the cost reduction program dates back to the first efforts in June 1961 when industry was advised of cost reduction objectives. A Navy Cost Reduction Group was established under the Chief of Naval Material. An internal Navy organization was developed to pursue cost reduction before the program was formally implemented in the Defense Department. With the aid of top level Navy support for the program, the cost reduction organization concentrated on pursuing the Navy's portion of the cost reduction goals.

Although the procedures used in implementing the Department of Defense Cost Reduction Program followed accepted principles, the program had problem areas. People have been perplexed over questions such as: Who should determine what

⁴Ibid., pp. 197-198.

defense should buy and what is a sound price? On these subjective questions there are many interpretations. "Sound price" and "defense needs" mean different things to different people. For example, a sound price by the buyer's standards may represent a loss by the seller's standards.

The fact that military personnel cannot receive the same incentive rewards as civilian personnel has also caused concern. The inequality of not being able to present monetary rewards to military personnel has established a basis for resentment between military and civilian personnel. It also represented a potential reason for personnel losing their enthusiasm for the economy effort. The program has suffered growing pains with organization, funds and the publicity program. In spite of conflicting but ever present political pressures from the President and the Congress, the program seems to be expanding.

This thesis is presented along historical lines with a chapter summarizing the principles and elements usually found in a cost reduction program. Chapters II, III and IV present a background appraisal of the philosophy, planning and events that brought the Department of Defense Cost Reduction Program to life. The Navy's implementation of the program is presented in Chapter V. Problems and future implications of the program are discussed in Chapter VI.

CHAPTER I

PRINCIPLES OF COST REDUCTION

The concepts of cost reduction, cost control, efficiency, economy, effective management or conservation of resources are closely aligned and to most people are essentially the same program. In this paper they will be considered identical since they all strive for maximum results with the minimum expenditure of resources. Business and government efforts to execute these programs are recorded throughout history. The motives of business and government for pursuing cost reduction are different but the principles and theory of implementing the programs are similar. Increased profits or market competition are usually cited as the driving forces that compel the private sector to adopt cost reduction programs.¹ But what motivates the public sector? This question has not been fully answered but the main forces are the responsibilities of public office and the desire for a higher position and more responsibility.² Still others feel that government is business and that a basic goal of every

¹Harold Seidman, "Increased Efficiency in Output Through More Effective Management" address before the Financial Management Institute, Philadelphia, Pa. February 6, 1963. p. 8.

²Ibid., pp. 8-9.

business is cost reduction.³ The motivation of the individual is essential in any economy program; but what steps must be taken to promote and establish a cost reduction program?

Much has been written about costs but most literature concerns cost accounting and ways to control costs in specific areas of operation. For instance, analysis of historical cost data and the use of cost accounting often reveal possible areas where costs could be reduced.⁴ The theories of cost analysis and cost accounting are germane to the cost reduction problem, but they do not explain how a cost reduction program is established. The implementation of cost reduction programs has been documented in articles written by top corporate executives and by reports of management and accounting associations. After examining the literature in this area, the many techniques and methods of implementation seemed to be contained in six principles.

1. Leadership
2. Integrated financial management
3. Responsibilities and goals
4. Team effort
5. Incentives and communications
6. Progress and control report system

³W. J. Littlefield, "The Controller's Contribution to Cost Reduction," The Controller, December 1959.

⁴Clarence B. Nickerson, Managerial Cost Accounting and Analysis, (2nd ed. rev.; New York: McGraw-Hill Book Company, Inc., 1962), p. 14.

All six of these interlocking principles are desirable if a cost reduction program is to be effectively introduced and utilized. Actual practice indicates that most cost reduction programs are a combination of several of these techniques or methods depending on the organization and scope of the program.⁵

Leadership

Experience also proves that programmed cost reduction in any business, large or small, must have one basic element if it is to succeed. That element is leadership. It must be spearheaded by an aggressive and imaginative leader.⁶

In order for a cost reduction program to be effective it must be supported and imposed by a central organizational authority. This central authority should be a top level member of the organization in order to provide leadership for the entire structure. Top authority is required to make decisions on the program and direct the follow through required to ensure compliance.

A prerequisite of the leader is that he must desire to reduce costs throughout the entire organization without

⁵E. Lee Talman, "Introduction: Discovering New Profit Opportunities," Control of Non-Manufacturing Costs, American Management Association Special Report No. 26, (New York: American Management Association, 1957), p. 8.

⁶American Institute of Certified Public Accountants, Cost Reduction and Cost Control in the Small Business, Management Services by CPAs Number 4, (New York: American Institute of Certified Public Accountants, 1960), p. 7.

prejudice, favoritism or differentiation toward any department.⁷ Although everyone would like to cut costs, the fact that most personnel would rather do other things first has emphasized the need for leadership. Analysis of costs and leadership lead Clement C. Caditz to coin three laws of cost control.

1. There is more profit in cost control when business is good than when business is bad.
2. Costs tend to increase in inverse proportion to the amount of effort expended on cost control.
3. The amount of effort expended on cost control tends to increase when business is bad and decrease when business is good.⁸

Cost reduction should be a continuous process. The job is not easy and its success or failure is in a large measure the result of the internal organizational climate created by the leadership of the top executive.⁹

The will to save and become efficient starts at the top and must be supported down the organization. Economy and waste reduction do not usually well up from the bottom. They usually come from above because "...Cost control is not an aid to management. Today it is its lifeblood."¹⁰ Cost

⁷Don F. Capell, "A Top-Down Approach to Cost Reduction," Cost Reduction at Work, American Management Association, Management Report No. 28, (New York: American Management Association, 1959), p. 8.

⁸Clement C. Caditz, "Some Plain Talk on Cutting Costs," Cost Reduction at Work, American Management Association, Management Report No. 28, (New York: American Management Association, 1959), pp. 41-42.

⁹Talman, op. cit., p. 5.

¹⁰Capell, op. cit., p. 8.

consciousness is not easy to sell. Leadership and realistic cost reduction objectives are necessary to provide the climate for its growth. These concepts embrace all the principles that Peter F. Drucker proposed in his management by objectives. Drucker's philosophies on managing the business, managing the managers, managing the work and workers are all essential to the cost reduction effort.¹¹ The proper objectives and environment will pave the way for easy administration of the program.

Since it is usually recommended that cost reduction programs be established on a formal basis, the planning and administration of the program is often assigned to a separate high level executive.¹² In large organizations a staff or task force is necessary to put the words of the executive into actions.¹³ This arrangement separates the top executive from the mundane details and allows him to aggressively pursue his primary duties of leadership, review of objectives and the establishment of total company-wide cost reduction goals.¹⁴ When setting objectives and goals the top executive must consider all company financial management matters. The cost reduction efforts should be integrated with all other

¹¹Peter F. Drucker, The Practice of Management, (New York: Harper and Brothers Publishers 1954), p. 5.

¹²Cost Reduction and Cost Control in the Small Business, op. cit., p. 7.

¹³Capell, loc. cit.

¹⁴Talman, op. cit., p. 10.

financial management considerations.

Integrated Financial Management

A cost reduction program should be a part of the regular activities of an organization with the objective of continuing improvement. Cost control is most effective when it is a part of a general program for better management.¹⁵ The cost reduction program must be compatible with budgeting, auditing, manpower and material management policies of the organization. To achieve a balanced cost reduction program it is first necessary to integrate all cost controls.¹⁶ The one-shot program isolated from other organizational activities is very seldom effective and "...there runs a definite vein of recognition that cost reduction as an isolated activity can do more harm than good."¹⁷

Cost reduction must be pursued throughout the organization. Individual efforts toward economy must be integrated into the over-all system of financial management.

There are many fertile fields for cost reduction in most management areas. Individual organizations and their activities determine what specific areas are most inefficient and which ones need tighter cost controls. Areas requiring

¹⁵Nickerson, loc. cit.

¹⁶p. K. Shoemaker, "Dynamic Cost Management," Cost Reduction at Work, American Management Association, Management Report No. 28, (New York: American Management Association, 1959), p. 14.

¹⁷National Association of Accountants, Cost Improvement Practice Report, NAA Bulletin Number 8, Vol. XLI, Number 2, (New York: National Association of Accountants, October 1959), p. 3.

cost reduction and control may have to be integrated into the total program one at a time, on some priority basis, but all areas should be earmarked for participation. Identifying these areas, developing improved controls and realizing the savings is a continuing process.

The old adage, "Nothing succeeds like success," certainly describes the organization that embraces the continuing-improvement philosophy.¹⁸

The program must be one of always lowering cost levels while maintaining effectiveness equal to the prior level. This is important because if the effectiveness of the operation is reduced, there really isn't a measurable savings.

One of the major financial management tools for imposing cost reduction on an organization is the budgeting process. The scope of this paper precludes a full discussion of this technique but a few thoughts on budgeting are appropriate. Strong budget pressure can be very persuasive in keeping costs in line. Planning and budgeting should reflect the expectation that we can and should achieve a steadily improving efficiency in our work.¹⁹ Efficient budgeting aids cost control by deciding where to spend money in relation to organizational objectives. Turning

¹⁸ Shoemaker, op. cit., p. 15.

¹⁹ Seidman, op. cit., p. 11.

this relationship around:

Cost control...a method or a series of methods whereby we try to make sure that budgeted expense is wise in the first place.²⁰

The complimentary use of budgeting and cost control can prove most effective in achieving economy. Regardless of the financial management activity under consideration, the program must follow a formal plan which defines responsibilities, goals and specifies who is responsible for what.

Responsibilities and Goals

The specific placement of responsibility is paramount to any cost reduction program. Unless management and personnel are thoroughly aware of their full responsibility in each area and what portion of the over-all goal they must meet, the system is doomed. The organizational structure and chain of command will dictate how clear the responsibility is at each level of management. Responsibility in any specific area should not be fragmented and each line manager must know to whom he is responsible and for what. Harold Seidman, Acting Assistant Director for Management and Organization, Bureau of the Budget, stated:

²⁰John A. Blum, "Expense Control in a Changing Business Environment," Control of Non-Manufacturing Costs, American Management Association Special Report No. 26, (New York: American Management Association, 1957), p. 24.

We regard it as essential that responsibility be assigned to the top line officer and be a line responsibility all the way down to the lowest echelon.²¹

Few people disagree with this statement and many couple it with the belief that a manager should be evaluated on the basis of his responsibilities and how efficiently and economically he controls his organization.

In evaluating a manager's performance, we must take into account the productivity of his organization as well as program accomplishments.²²

The question of how to set the total goal and specify who is responsible for how much becomes paramount since it will be against these goals that management will be evaluated. A forecast of some type is required to set the total goal. As previously mentioned, the top executive should determine the goal but he must have factual knowledge to know how high to set his sight. This data may come from his controller or his cost reduction staff. The goal should be significant but to insure future success to the cost reduction program it should be one that can be readily accomplished. Nothing sells a program faster than early success in a well recognized activity. It is best to set moderate goals and expand as the program gains momentum.

Distribution of the total goal among the departments is difficult. There are basically three ways that this can be done. The first and second method are essentially the same.

²¹Seidman, op. cit., p. 9.

²²Ibid.

Either a flat cut across the board of sufficient size to meet the goal or a reduction of all department funds by a certain percentage to meet the goal.²³ Neither are desirable because they merely teach managers to over budget in expectation of a cutback, hurt the small departments and are unfair to the more efficient departments. The third method is to thoroughly analyze the operations of all departments and then impose cost reduction goals according to the waste involved in each department.²⁴ This procedure not only makes sense but promotes trust and confidence in the objectives of the program to reduce waste. Setting realistic goals and objectively assigning required accomplishments will help set the proper attitude, which in turn, will allow each successive level of management to add its impetus to the drive to achieve each successive goal or objective.²⁵

Team Effort

Cost reduction is not a program that is accomplished solely by top management. It is a team effort of every member of the organization. Today there are many scientific management aids such as electronic computers, operations research and management engineering to help the private and public manager. They are effective tools in promoting

²³Blum, op. cit., p. 20.

²⁴Talman, op. cit., p. 10.

²⁵Shoemaker, op. cit., p. 15.

efficiency but in the final analysis the art of good management is still a "people problem."²⁶ Management is often defined as the act of getting things done through people and the area of cost reduction is no exception to this rule. The top executive must provide the leadership in starting the program and keeping it alive, but it will be the ideas, activities and participation of the employees that will prove to be of most benefit to the program.²⁷ Cost reduction is usually "...accomplished by a series of undramatic but systematic efforts -- relatively small improvements which are not earth-shaking in their individual importance but which, in the aggregate, can be made to add up to an impressive total."²⁸ These small efforts for efficiency performed by individuals which improves the entire operation are often called suboptimization, or efficiency in the small.²⁹ However, everyone must have a clear vision of the end goal of the organization and the cost reduction program. Instilling cost consciousness requires the authority

²⁶ William F. McKee, General, USAF, "Good Management is Everybody's Business," The Journal of the Armed Forces Management Association, Vol. 2, No. 1, (February 1962), p. 6.

²⁷ Cost Reduction and Cost Control in the Small Business, op. cit., p. 12.

²⁸ Talman, op. cit., p. 5.

²⁹ Charles J. Hitch and Roland N. McKeen, The Economics of Defense in the Nuclear Age, (Cambridge: Harvard University Press, 1960), pp. 125-128. "Efficiency in the small, or at relatively low levels, involves making use of the resources allocated to each mission and the numerous subordinate jobs within each."

and enthusiasm of the top executive, the ability of middle management and supervisors to motivate other personnel and everyone must acquire a state of mind and habits that reflect economy in daily operations.³⁰ Motivating personnel is the hardest task, for what stimulates one person may not offer an incentive for the next.

Incentives and Communications

The motivation of personnel to act in a desired manner is a major human relations problem. Establishing an attitude of acceptance within the organization for the cost reduction program is usually accomplished by the environment and incentives. Emphasis is often put on the incentives. Incentives may be positive or negative but the negative incentives such as demotions, fines or social penalties are not stressed. Likewise this discussion will be restricted to the positive rewards which generally can be divided into financial and non-financial rewards. Monetary rewards are good but are not always effective. Non-financial rewards usually provide the person with recognition, a sense of accomplishment and the satisfaction of a job well done.³¹ Each situation may require a specific or a combination of incentives. To some extent the position that a person occupies in the organizational hierarchy will dictate the

³⁰ Cost Reduction and Cost Control in the Small Business, op. cit., pp. 11-12.

³¹ Talman, op. cit., p. 12.

proper incentive.

The motives of top business executives are generally considered to be profits and position, while top government officials strive for position and responsibility. Most of the other people down the line in either sector are motivated by similar attitudes, desires and drives. These include "...the desire for promotion, more responsibility, interest in the work involved, the feeling of being on a good team that is accomplishing something useful and so on."³² Given leadership and proper incentives, public employees are just as interested in doing a better job as those employed by private enterprise.³³

One of the most vital parts of the program is communications. Everyone must be informed of the program, its basic objectives, its goals and their responsibilities. Personnel must then be keep informed of total program and separate department progress. In addition, the communications system must advise everyone of the available rewards and individual achievements. People want others to know of their efforts. It is essential that publicity be given to program accomplishments.³⁴ The communications media maybe a publication, newsletter, report or honorary dinner but

³²Seidman, op. cit., p. 12.

³³Ibid.

³⁴Cost Improvement Practice Report, op. cit., p. 10.

it should be designed for the scope of the program and the size of the organization.

Progress and Control Reports

In this area there is varied opinion as to what type of reports or information is required and how often it should be submitted. The first premise is that costs can only be effectively reduced and controlled if the organization has adequate cost information.³⁵ The second premise is that some system of follow-up inspections, audits or reviews are necessary to determine if the goals and performance are being met.³⁶

The six previously discussed principles for introducing and administering a cost reduction program all add to the effectiveness of the system. However, there seems to be a need for a balanced program which stresses all areas without over emphasizing anyone. Leadership appears to be the key to a balanced cost reduction system that equally stresses planning, cooperation and action. Defense Department and Navy actions to implement cost reduction will now be viewed and evaluated in light of these principles.

³⁶Seidman, op. cit., p. 11.

CHAPTER II

BACKGROUND PRESSURE FOR ECONOMY IN DEFENSE

The size, complexity and cost of national defense has held the public attention since World War II. Political administrations have placed emphasis on defense management in an attempt to obtain efficiency and reduce waste. The Department of Defense Cost Reduction Program has those same basic aims. Its roots are founded in presidential, congressional and national concern over defense expenditures. Strict central control by the Secretary of Defense has formed its trunk. Its branches are integrated with other planning, programming, financial and decision making activities.

The Department of Defense Cost Reduction Program that has evolved since 1960 was fostered by many individuals in and outside of government. The ideas of economy and efficiency in defense activities were often quoted but seldom, if ever, practiced on a department wide basis. Individual military services previously had efficiency and economy programs, but they were not coordinated and emphasized by a central control. The budget was the main force that previously stressed the necessity for economy. A service had to live within its budget. However, the defense budget grew each year. The increased cost of weapons and the

frequent reports of waste brought the condition into sharp focus in the late fifties. A management program that produced more than words or promises of economy was required.

Guidance for the Secretary of Defense

The change of administration in the federal government after the 1960 elections resulted in the appointment of Robert S. McNamara as Secretary of Defense. With him appeared a new approach to defense management. His basic philosophy was that the civilian defense secretary, not military officers, must truly be in charge of the Pentagon.¹ After hearing the facts and attempting to ignore the emotional arguments of the situation, his decisions were given to the military services to carry out rather than for opinions.² This point of view is consistent with the concept of civilian secretaries in charge of the separate services, and with the United States Constitution which in Section 2 of Article II designates the President as Commander and Chief of the Army and Navy and preserves the American tradition of strict civilian control over the military professionals.

The genesis of defense cost reduction might well be drawn from the first instructions the President gave Secretary McNamara for revision of the fiscal year 1962 budget prior to the administration taking office. Those

¹"Defense Overhaul Improves Weapons, Cuts Waste," Nation's Business, August 1961, p. 64.

²Ibid.

instructions were:

1. Develop the force structure necessary to our military requirements without regard to military budget ceilings.
2. Procure and operate this force at the lowest possible cost.³

Congress was also concerned with the growing defense expenditures and inefficiency in defense management. Senator Paul H. Douglas wrote a personal letter to Mr. McNamara in December 1960 expressing his concern over the waste in defense procurement and supply systems and enlisting Mr. McNamara's support for an economy program.⁴ The same concern was voiced during many hearings before congressional subcommittees on military affairs and appropriations. As the Secretary McNamara himself stated the Department of Defense Cost Reduction Program was not a one-man operation; but emanated from the President, Congress, the Bureau of the Budget, the General Accounting Office and many individuals, both inside and outside of the Department of Defense.⁵

Secretary of Defense Management Philosophy

Secretary McNamara had to produce an effective program. Everyone gave him advice and guidance, but the

³Robert S. McNamara, Secretary of Defense, Memorandum for the President, July 5, 1962, p. 1.

⁴Letter from Senator Paul H. Douglas to Mr. R. S. McNamara, December 30, 1960.

⁵Robert S. McNamara, Secretary of Defense, Department of Defense Press Conference at the Pentagon, July 6, 1962, (transcript), p. 2.

responsibility for action was on his shoulders. Before he could effectively start a cost reduction program in the Defense Department his concepts of management had to be established. Several basic areas of defense management had to be strengthened to give him the control required to manage the department. Efficiency and economy were impossible without controls. Secretary McNamara's formula for better management included significant improvements in the decision making process, organizational structure, program evaluations, alternative systems and budgeting.⁶

The first concept was that decision making would move more swiftly with civilian leaders in firmer control in the Defense Department than with military men. Generalities and intuition had less influence on Secretary McNamara who desired items quantified for comparison. This concept rested on the premise that the civilian, being free from service tradition and rivalry, could concentrate and absorb facts objectively while ignoring the service emotional arguments.

The organizational structure of the Defense Department was the second area needing strengthening and streamlining. Proper control could not be exercised without an adequate organization and proper procedures. When Secretary McNamara was asked by Congressional Committees if he was satisfied

⁶"Defense Overhaul Improves Weapons," op. cit., p. 62.

with defense operations and procedures, he replied:

I am not satisfied. I believe satisfaction is the opponent of progress, the enemy of progress, and I am certainly not satisfied. We have a number of problems that we are facing. For most of them, we have been able to develop a plan for solution. We have not solved all of them yet by any manner of means.⁷

The third item concerned the evaluation of programs and the abandonment of less promising weapons and obsolete bases to reduce costs and make funds available for other necessities. Most of the savings of the cost reduction program were to be achieved in this manner. Secretary McNamara's view on how savings could be achieved was:

It is my personal view that savings cannot be anticipated as a result of force reductions, either in the nuclear or the nonnuclear portions of our forces. Rather, the savings, which I believe we can achieve and I think we must achieve, must come, in my opinion, from increases in efficiency in management and administration.⁸

Lastly, the military budget needed revamping to better assess costs of alternative weapons with less dependence placed on rival claims of the various services for pet projects.

Integrated Financial Management

Evidently the office of the Secretary of Defense was keenly aware that a cost reduction program could not be

⁷Hearings, Department of Defense Appropriations for 1964, Part I, Secretary of Defense, op. cit., p. 242.

⁸Ibid. p. 470.

instituted in the department until information and control systems were established. Costs can only be reduced if they can be defined and controlled.⁹

In response to President Kennedy's second basic instruction to procure and operate the defense force at the lowest possible cost, the Defense Department moved in three directions. The Secretary of Defense explained these actions toward better management in this way:

First, we have instituted a new programming and budgeting procedure under which our requirements for forces, weapons, and support elements are evaluated in relation to the principal military missions of the Defense Establishment, rather than by organizational component. This procedure has permitted us to identify and eliminate overlapping and duplicative systems, and to set objectives for tri-service systems where they are clearly suitable.

Second, we have projected our requirements by major missions five years into the future, and have computed the long-term costs of development, capital investment, and operation. This innovation is making our cost-effectiveness studies far more meaningful, thus leading to sounder decisions as to those programs which should be accelerated -- and those which should be stretched out, deferred or terminated.

Third, we are giving intense scrutiny to our procurement and logistics policies since seventy per cent of every Defense dollar is spent on purchasing, construction, operating depots and bases, maintenance, transportation and communication services.¹⁰

The first action was the program-package concept to integrate the planning, programming and financial management

⁹Cost Reduction and Cost Control in the Small Business, op. cit., p. 14.

¹⁰McNamara Memorandum for the President, July 5, 1962, loc. cit.

functions for better decision making.¹¹ Program packaging was essentially a four step process which included:

(1) programming which was first determining what forces were needed and secondly, time-phasing the attainment of those forces into the structure, (2) a study of the size of the needed forces and the equipment required to make them effective, (3) the interpolation and documentation of the programs devised in the first two steps into the budget and (4) financing the program or executing the budget.¹²

Budgets presented under this concept place primary emphasis on the military mission rather than the service.¹³

Implementation of the program-package concept started in the summer of 1961.

The second action was the Five Year Force Structure and Financial Plan which projects major missions into the future. Mission planning on a five year basis greatly aided decision-making, cost-effectiveness studies and spotlighted duplication. The Five Year Force Structure and Financial Plan, commonly called the "book", and the program-

¹¹Lot Ensey, Program Change Control System in the Department of the Navy, U.S. Department of the Navy, Office of the Controller, NAVEXOS P-2416, (Washington: Department of the Navy, August 1962), p. 1-1.

¹²Office of the Secretary of Defense, "Comptroller," Armed Forces Management, November 1963, p. 68.

¹³U.S., Department of Defense, Programming Systems for the Secretary of Defense, Study Report, (Washington: Office of the Assistant Secretary of Defense (comptroller), June 25, 1962), p. 1-1.

packages had elaborate reporting and control systems to provide the Defense Department with performance, planning and control information.

Charles J. Hitch, Assistant Secretary of Defense (Comptroller), reported to Congress that this improved financial management system was designed to assemble, consolidate and present the physical programs of the services.¹⁴ It was to translate those physical programs into financial summaries and present them in several ways, such as period of time, investment, annual operating costs, obligations, mission, etc. The system was also to provide the total financial implications of new or alternative programs.

The last action taken by defense referred to the Department of Defense Cost Reduction Program. It was a vital financial management tool but could not function effectively without the first two programs. The interrelation was aptly stated by Secretary McNamara speaking about defense procurement.

...before we can intelligently decide what to buy, we must first determine precisely what is needed, and what is needed must be directly related to

¹⁴U.S., Congress, House, Subcommittee of the Committee on Appropriations, Hearings, Department of Defense Appropriations for 1962, Part 3, Secretary of Defense, 87th Congress, 1st Session., 1961, p. 541.

realistic and soundly conceived military plans and policies.¹⁵

Having first mastered the plans, policies and requirements phase it would be easier to procure and provide logistic support efficiently. The three programs were almost inseparable.

The decision to concentrate cost reduction in the procurement and logistic areas was very prudent. Not only were most defense funds expended in those areas, providing the greatest opportunity for savings and initial program success, but the control of these activities was mainly centered in Washington D. C. Control of the operating forces and field activities can sometimes become difficult because of the filtering and fragmental characteristics of the organization. It was imperative the cost reduction program be launched in areas where the Office of the Secretary of Defense had direct control. The program could be expanded as the cost reduction program and Defense Department controls spread throughout the organization.

From these concepts an integrated approach to financial management in the Department of Defense came to life. Not that it appeared over night, nor that it has been completed at this writing, but the basic guidance and

¹⁵U. S., Congress, Subcommittee on Defense Procurement of the Joint Economic Committee Congress of the United States, Hearing, Impact of Military Supply and Services Activities on the Economy, 88 Congress, 1st Session, pursuant to Sec. 5 (a) of Public Law 304 (79th Congress), March 28, 29, 1963, p. 16.

philosophies were established with which the Department of Defense would be managed. This management and leadership was essential to the cost reduction program.

CHAPTER III

HISTORICAL DEVELOPMENT OF DEFENSE COST REDUCTION

The first statement referring to the formal Department of Defense Cost Reduction Program occurred in June 1961 at the Joint National Security Industrial Association and Department of Defense Cost Reduction Symposium where industry was briefed on the proposed defense efforts to cut costs. Cost reduction was not publicized again until 5 July 1962. In 1961 and early 1962 defense efforts were concentrated on the establishment of the program-packaging system and the Five Year Force Structure and Financial Plan. Once these control systems were in operation, the cost reduction program could be integrated into them. Cost reduction goals and areas were established in July 1962. Detailed planning and organizing of activities commenced in September 1962.

Impact of Cost Reduction on Industry

The first defense actions toward cost reduction were directed to private industry. At first this seems surprising but the objectives of the Secretary of Defense, as disclosed at the National Security Industrial Association Symposium in June 1961, were to include defense contractors as an

integral part of the defense cost reduction effort.¹ At this symposium contractors were appraised of their public responsibilities as defense suppliers and the intention of defense to shift to more competitive and incentive contracting. Full exploration into the effect of the Department of Defense Cost Reduction Program on industry is beyond this paper. However, the major implications of cost reduction on industry are discussed briefly to show their relationship to the intradepartment program.

Mr. McNamara was Secretary of Defense for less than two months when he wrote the president of the National Security Industrial Association asking him to sponsor a symposium to explore the theme of "The Profit Motive and Cost Reduction."² The symposium, held 15 June 1961, was an appeal for joint action and a statement of defense objectives in cost reduction. Secretary McNamara's opening remarks set the stage for the forth coming Department of Defense Cost Reduction Program and expressed the path and impact the program would have on industry. The following excerpts were taken from his opening remarks:

We are planning a wide variety of other actions to reduce unnecessary costs but,...."We in Defense cannot do this job alone." We must rely heavily on our contractors. We can only succeed through a

¹Robert S. McNamara, Opening remarks before the National Security Industrial Association Cost Reduction Symposium, Washington D.C., June 15, 1961, pp. 1-6.

²Ibid., pp. 1-2.

joint effort with you and people like you. Half of the more than \$40 billion we spend each year fiscal year 1961 goes for the day-to-day operating cost of the Defense Establishment -- military personnel and operation and maintenance. Economy in this area is primarily the responsibility of Defense management. The other half of the \$40-odd-billion a year goes for major procurement, research, development, test and evaluation and military construction; i.e. goods and services which you in industry furnish to the defense Department. Here we share the responsibility for economy and efficiency with you. You spend this money for us, and, for all practical purposes, act as our agents.³

Value engineering and analysis as well as contracting were stressed in subsequent communications and other symposiums with industry.⁴ As an example, a top level letter from the Bureau of Naval Weapons to 140 contractors reviewed the cost reduction program and the importance of increasing the emphasis on value engineering.⁵ Jointly sponsored National Security Industrial Association and Defense Department Value Engineering Symposiums were conducted in major cities throughout the U.S.⁶ At those symposiums, stress was placed on the idea that industrial profits would go up and defense cost would come down when

³Ibid., pp. 2-3.

⁴M. E. Jones, "Policy Statement on VE," Aerospace Management, June 1963, p. 35.

⁵Secretary of the Navy memorandum for Assistant Secretary of Defense (Installations and Logistics), March 13, 1963, Attached Item.

⁶"Symposiums Highlight Value Engineering Importance," DOD Cost Reduction Report, (Washington: Office of the Assistant Secretary of Defense (Installations and Logistics), December 1963), pp. 1-7.

unneeded qualities (goldplating) were removed from weapon systems.

Recent emphasis has been placed on having industrial contractors set up their own cost reduction program. President Johnson and Secretary McNamara sent letters to 7,500 contractors in December 1963 urging cost reduction programs be instituted in contractor organizations.⁷ Rewards for contractors establishing cost reduction programs were to include more favorable performance ratings and higher fees on contracts.⁸ Proven savings that result from those cost reduction programs were also to count in the competition for future contracts. The first step in this effort was to develop a means by which contractors could be graded or evaluated as to their economy efforts. Defense asked the 100 largest military contractors to comment on suggested criteria for evaluation of their own cost reduction programs.⁹ As a minimum the contractors would have to establish a specific organization, set goals and submit progress reports to the Defense Department.

The reduction of costs was possible with mutually sound objectives. Therefore, contractors had to be kept appraised of what the Defense Department was doing in the area of cost reduction. For this reason industry was

⁷The Wall Street Journal, February 11, 1964, p. 9.

⁸"Washington Roundup - Economy Rewards," Aviation Week and Space Technology, February 17, 1964, p. 25.

⁹Ibid.

continuously briefed and urged to participate in the program.

Memorandum for the President, 5 July 1962

The next mile stone in the Department of Defense Cost Reduction Program, often called the first step, was a Secretary of Defense memorandum for President Kennedy on July 5, 1962. This memorandum report outlined the progress since January 1961 in cutting the cost of defense logistics and program goals for the next five years. As a result, the Defense Department was committed to specific objectives and goals in cost reduction. The annual savings specified in the report were to "...result from the more efficient management of our logistical system and will not be achieved through a reduction in the strength of our combat forces."¹⁰ This one fact had been often misunderstood. The scope of the Department of Defense Cost Reduction Program was concentrated in the areas of procurement and logistics. The broad program objectives specified by the President to procure and operate the military forces at the lowest possible cost definitely left the door open for expansion of the efficiency program to the level of the operating forces. To date the program has not expanded that far. As President Kennedy stated:

What is particularly encouraging is that the economies in defense procurement and logistics

¹⁰McNamara, Memorandum for the President, July 5, 1962, op. cit., p. 2.

can be achieved without impairing operational effectiveness.¹¹

The first step in the cost reduction program was to set the overall goals to be achieved. The Secretary of Defense, based on forecasts, initially established the Department of Defense goal to be a \$3 billion per year reduction in costs to be achieved within five years (by fiscal year 1967).¹² An estimated \$750 million of the total program goal was to be realized in fiscal year 1963.¹³

Many people in and out of government were rather confused, and some still are, as to the relationship among cost savings, defense programs, defense appropriations and tax plans. Did the \$3 billion savings each year reduce the defense budget \$3 billion each year? The Air Force explained it this way:

The truth is that any money saved in Defense, whether on paper or in hard cash, will not be returned in bulk to the taxpayer and lower the tax bill by...billion dollars every year.¹⁴

Congress also questioned these savings and asked Secretary McNamara to explain:

Senator Robertson. You said we will spend \$2,400 million and save \$2,700 million, or was that \$2,400 million, too?

¹¹ Kennedy, op. cit., p. 1.

¹² McNamara, memorandum for the President, July 5, 1962, loc. cit.

¹³ Ibid.

¹⁴ Joe Wagner, "Air Force Cost Reduction: We'll Save Money and Thus Afford Better Weapon System," Armed Forces Management, February 1964, p. 21.

Secretary McNamara. No; I believe I said we will spend \$2,400 million more than we did last year and we will save something on the order of \$1 to \$1.9 billion that we otherwise would have spent had we not carried out the cost reduction programs that we have to date.

Senator Robertson. I thought you said you claimed this year you were going to save \$1 billion and 1964 you save \$2,700 million. Am I wrong again?

Secretary McNamara. No; I think that is correct.

Senator Robertson. You are going to spend several billion more in 1964 and save \$2,700 million.

Secretary McNamara. That is correct.

Senator Robertson. I am sure you have the explanation of that, but for the layman I don't understand how these things work out. Would you explain that for the record?

Secretary McNamara. Yes.

Cost Reduction Program

We are going to spend more, at the same time that we state that we have a substantial cost reduction program underway which is yielding savings.

Is this a contradiction? No. Instead of spending \$2,400 million more, we would be spending something on the order of \$4 billion plus more had we not had the cost reduction program underway.

Senator Robertson. I wanted you to explain it. Except for your efficiency program, it would go through the ceiling. It would be \$2.7 billion more in 1965, \$3.5 billion in the next year, and on until it hit the ceiling.

Secretary McNamara. That is correct.

Senator Robertson. But you are going to cut it down.

Secretary McNamara. That is correct.

Senator Robertson. Through your efficiency program.

Secretary McNamara. That is correct. I think we have only scratched the surface. I

think the question is why aren't we doing more and doing it faster.¹⁵

After stating the monetary goal of the program, the memorandum for the President outlined the areas and activities by which the savings would be realized. Basically, the savings were to be achieved in three ways.

1. Buying only what we need to achieve balanced readiness.
2. Buying at the lowest sound price.
3. Reducing operating costs through integration and standardization.¹⁶

These three major programs were further divided into specific cost reduction areas at a later date by the Cost Reduction Steering Committee.

The concept of "buying only what defense needs" was concerned with (1) setting inventory requirements at a realistic level and using existing inventories more efficiently, and (2) eliminating unneeded qualities (goldplating) from weapon systems specification. Value engineering and analysis were instrumental in accomplishing the reduction of goldplating.

Buying at the lowest sound price concerned contracting. Defense was striving for more price competition in contracting

¹⁵U.S., Congress, Senate, Subcommittee of the Committee on Appropriations, Hearings, DOD Appropriations for 1964, H.R. 7179, 88 Congress, 1st Session, 1963, pp. 179-180.

¹⁶McNamara, Memorandum for the President, July 5, 1962, loc. cit.

by competitive bids rather than sole source procurement. The type of contracts used were also to change. Stress was placed on using fixed price and incentive contracts wherever possible, rather than the popular cost-plus-fixed fee contracts. These first two major programs were of vital interest to private industry. Industry was now observing the defense follow up to the cost reduction objectives put forth at the 1961 National Security Industrial Association Symposium.

The last major program was primarily aimed at internal Defense Department savings that could be achieved through integration and standardization of activities. Unnecessary overhead at bases and installations was reduced and unneeded activities closed. Standardization of procurement and logistic paper work was introduced to reduce administrative expenses. More effective management was proposed for supply, communications, transportation, equipment maintenance, and the operation and maintenance of real property.

Thus implementation of the cost reduction program continued to follow accepted steps. The top executive in the Defense Department had set the goals and objectives making the cost reduction program a reality. Now the goals had to be divided among the services and detailed plans devised to meet the goals.

Thomas D. Morris, Assistant Secretary of Defense for Installations and Logistics, was assigned the responsibility for the program.¹⁷ Assistant Secretary Morris was to work with the materiel secretaries of each department to develop specific annual goals for achieving the cost reductions and techniques of measuring the progress of each department on a current basis.¹⁸

The next action came on July 26, 1962 when the Department of Defense required the increased use of price competition by each department.¹⁹ Defense specified the competitive contract goals that each department should meet through 1965. Most contracts had been under surveillance since fiscal year 1961 so this was not a new program.²⁰ One question remained: When would the goals reported to the President on July 5, 1962 be implemented? It wasn't until September 1962 that concerted pressure was put behind the cost reduction program to further involve the departments and require action.

¹⁷ Department of Defense Press Conference, July 26, 1962, op. cit., p. 1.

¹⁸ Secretary of Defense memorandum for the Secretaries of the Military Departments, Subject: Defense Department Cost Reduction Program, September 14, 1962.

¹⁹ Assistant Secretary of Defense (Installations and Logistics) memorandum to the Assistant Secretary of the Navy (Installations and Logistics), Subject: Procurement Goals Fiscal Year 1963-1965, July 26, 1962, p. 1.

²⁰ Ibid.

Call for Action: September 14, 1962

The signing of three memoranda on September 14, 1962 established the next significant date in cost reduction history. As a result of those memoranda the cost reduction effort came alive. The department secretaries and agency directors were informed by the Secretary of Defense in the first memorandum of the cost reduction goals and areas, and were asked to furnish specific plans of action by October 15, 1962.²¹ In the second memorandum, Assistant Secretary Morris asked his counterparts in the military departments and agencies to designate representatives to meet with Mr. Altizer in committee to formulate plans, goals, and determine the means of measuring program progress.²² The last memorandum appointed Mr. Harrell Altizer as head of an interservice working group, later called the Department of Defense Cost Reduction Program Steering Committee, which gave continuing attention to program progress and performed required joint planning.²³ This committee became the core of the cost reduction effort.

²¹ Secretary of Defense memorandum, September 14, 1962, loc. cit.

²² Assistant Secretary of Defense (Installations and Logistics) memorandum to the Assistant Secretary of the Navy (Installations and Logistics), Subject: Cost Reduction Program, September 14, 1962, p. 1.

²³ Assistant Secretary of Defense (Installations and Logistics) memorandum to Mr. Harrell Altizer, Subject: Establishment of an Interservice Working Group to Establish Targets and Keep Score on the Progress of the Cost Reduction Program, September 14, 1962, p. 1.

Secretary McNamara's memorandum of September 14, 1962 to the military departments and defense agencies was the required spearhead to put the cost reduction program in motion. His aggressive support of the program and his desire for action were expressed in the memorandum.

I consider this to be a matter of highest priority and would like to receive from you by October 15, 1962 an outline of your specific plan of action for FY 1963 and projected accomplishments through FY 1967.²⁴

The planning required by the Secretary of Defense memorandum was performed by a cost reduction committee composed of representatives of each service and agency. Assistant Secretary Morris' memorandum to his counterparts in the military departments was to obtain representatives that would concentrate their major effort toward the program. The memorandum that designated Mr. Altizer as chairman of the cost reduction steering committee also specified tasks the committee was to accomplish.

The first task was to immediately establish specific targets and then gradually refine and improve them.²⁵ Each target was to be documented in quantitative terms. Either a dollar or a percentage improvement goal was to be used wherever possible. A systematic recording of accomplishments

²⁴ Secretary of Defense memorandum, September 14, 1962, loc. cit.

²⁵ Assistant Secretary of Defense (Installations and Logistics) memorandum to Altizer, September 14, 1962, loc. cit.

in dollar terms was a minimum requirement for those subject areas where quantitative targets could not be set.

The second task was to design the format and content of: (1) the regular reports submitted by the departments and (2) the periodic summary report for the Secretary of Defense.²⁶

The third task was to establish an appropriate communications program for internal and external publicity.²⁷ This communications program was to achieve wide-spread awareness of the program in all departments and give suitable recognition to those who produced program results.

The Steering Committee became the right arm of the Assistant Secretary of Defense by converting the words and objectives of the cost reduction program into action. The position of the Steering Committee in the Department of Defense is shown in Chart I, page 45.

Defense Cost Reduction Steering Committee Action

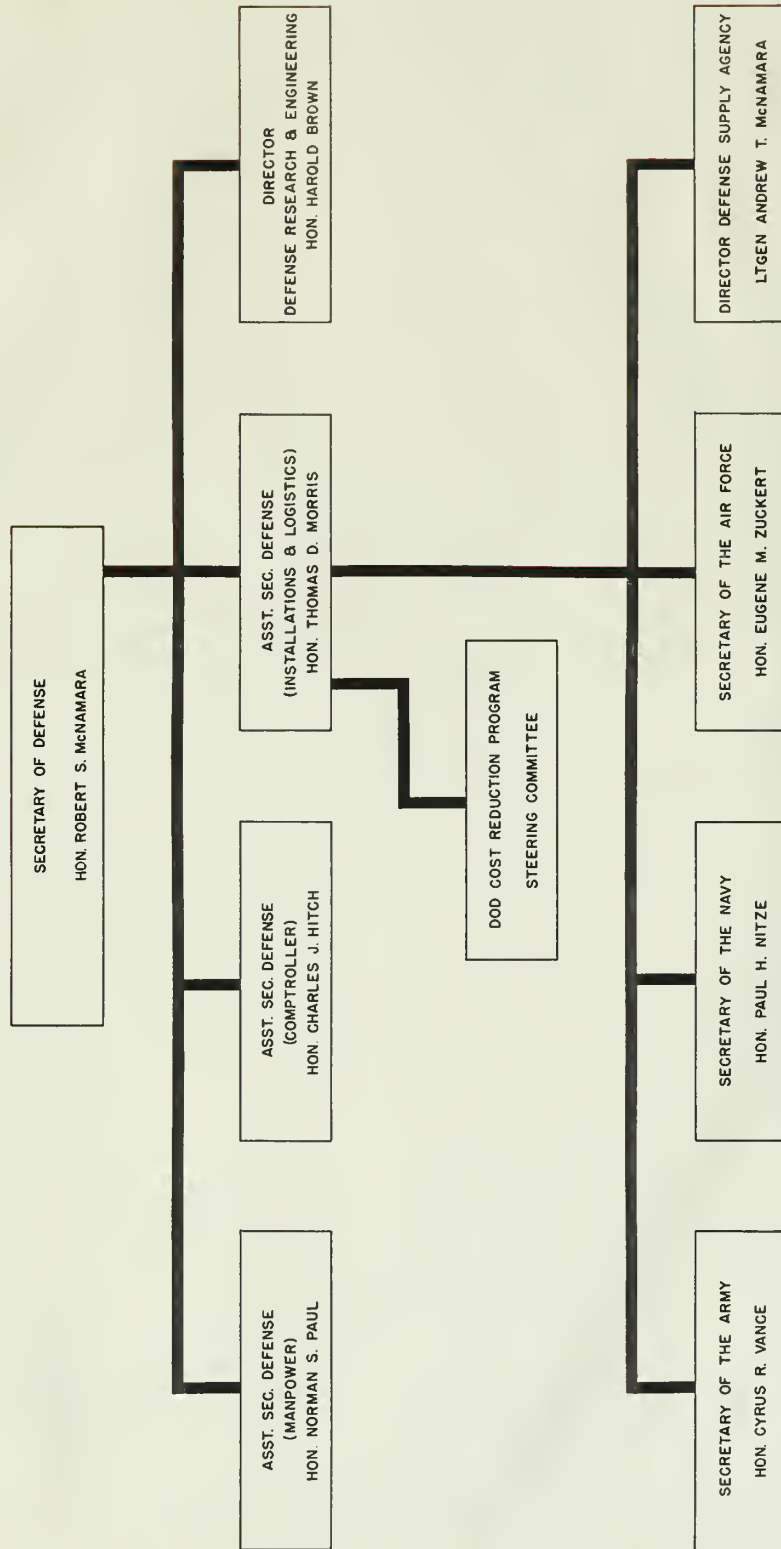
The Secretary of Defense requested action on Friday, September 14, 1962. The services were quick to react. The first meeting of the Cost Reduction Steering Committee was held Monday, September 17, 1962.²⁸ At this first meeting,

²⁶ Ibid., p. 2.

²⁷ Ibid.

²⁸ Memorandum for File -- Number 1, September 18, 1962, Report on first cost reduction meeting held on September 17, 1962, in Assistant Secretary Morris' office, (in the files of the Navy Cost Reduction Program Group).

DEPARTMENT OF DEFENSE COST REDUCTION PROGRAM



the committee was briefed on the tasks they were to perform. During the initial phase of planning the committee met almost every day to quantify and determine individual service goals. All major cost reduction areas were discussed to explore the possible savings in each area.

The aid of professional specialists enabled the Steering Committee to develop the specific cost reduction areas.²⁹ Those areas were called sub-group items and are listed in table I, page 47. Cost Reduction Sub-Groups, containing members of each military department and agency, were organized to pursue efforts in each of these cost reduction areas. Basic guidance and procedures for the program were given to the Sub-Group Committees on November 19, 1962.³⁰ The Sub-Group Committees were to support the Steering Committee by developing goals, establishing techniques of measuring program progress and making reports. Individual sub-group members also reviewed and evaluated data from their respective departments, kept the Steering Committee informed of problems and established liaison within his parent organization to insure that adequate attention was given at every organizational level to assure successful attainment of established goals.³¹

²⁹ Assistant Secretary of Defense (Installations and Logistics) memorandum to Altizer, September 14, 1962, loc. cit.

³⁰ Office of the Secretary of Defense (Installations and Logistics) memorandum to all Members of the DOD Cost Reduction Steering Committee and Sub-Groups, Subject: Basic Guidance and Procedures for the DOD Cost Reduction Program, November 19, 1962, p. 3.

³¹ Ibid.

TABLE I

DOD COST REDUCTION PROGRAM SUB-GROUPS

Sub-group items

1. MAJOR ITEMS OF EQUIPMENT
2. INITIAL SPARES PROVISIONING
3. SECONDARY ITEMS
4. TECHNICAL MANUALS
5. EXPANDING AND MAINTAINING THE DEFENSE INDUSTRIAL PRODUCTION BASE
6. EQUIPMENT AND SUPPLIES
7. IDLE PRODUCTION EQUIPMENT
8. EXCESS CONTRACTOR INVENTORY
9. DSA INVENTORY DRAWDOWN
10. ELIMINATING GOLDPLATING
11. INVENTORY ITEM REDUCTION
12. SHIFT FROM NON-COMPETITIVE TO COMPETITIVE PROCUREMENT
13. SHIFT FROM CPFF TO FIXED OR INCENTIVE PRICE CONTRACTING
14. PERT
15. TERMINATING UNNECESSARY OPERATIONS
(BASE UTILIZATION)
16. CONSOLIDATION OF 16 REQUISITIONING SYSTEMS
INTO ONE ON 7/1/62 (MILSTRIP)
17. CONSOLIDATION OF 81 TRANSPORTATION DOCUMENTS
INTO ONE (MILSTAMP)
18. REDUCTION OF CONTRACTOR REPORTS

TABLE I
CONTINUED

19. DSA OPERATING EXPENSE SAVINGS
20. DCA AND COMMUNICATION SYSTEM SAVINGS
21. IMPROVING TRANSPORTATION AND TRAFFIC MANAGEMENT
22. IMPROVING EQUIPMENT MAINTENANCE MANAGEMENT
23. ADMINISTRATIVE VEHICLE MAINTENANCE MANAGEMENT
24. IMPROVING MILITARY HOUSING MANAGEMENT
25. IMPROVING REAL PROPERTY MANAGEMENT
26. SALE OF SURPLUS PERSONAL PROPERTY
27. PACKAGING, PRESERVING AND PACKING
28. USE OF CONTRACT TECHNICIANS
29. ADP SYSTEMS, IMPROVED OPERATION AND MANAGEMENT

Many people have thought that the birth date of the Department of Defense Cost Reduction Program was October 1962. This belief developed from the concerted effort put forth by the military departments in October to plan the programs and establish goals. At this point, all cost reduction activities became integrated and were the cooperative effort of all departments through the action of the Steering and Sub-Group Committees. Individual, as well as cooperative action was required to plan, refine, organize and alter goals. Department plans of action were reported to the Defense Department on October 18, 1962.³²

In a way, the 18 October report marked the shift from Defense Department action to individual department actions. The functions of the Defense Department then tended toward review and approval of cost reduction goals, issuing instructions and monitoring the program. Steering Committee efforts moved toward supervision, coordination and compilation of data required by the Department of Defense. The most significant Department of Defense and Steering Committee actions that occurred after October 1962 but prior to formal implementation were:

1. Revise Overall Goals. In October 1962 the Secretary of Defense reduced the time span for accomplishing

³²Assistant Secretary of Defense (Installations and Logistics) memorandum for Secretary of Defense, Subject: Cost Reduction Goals for Procurement and Logistics, October 18, 1962, p. 1.

the cost reduction goals from a five year to a three year program (fiscal years 1963-1965).³³

2. Cuban crisis. The Defense Department decided to continue the cost reduction program inspite of the Cuban situation.³⁴ The rationale behind this decision was that efforts to improve logistics management should not be affected by an emergency. It was recognized that previously established goals might have to be adjusted in consideration of action required by the crisis.

3. Department program goals. The Secretary of Defense approved the cost reduction goals of each department on January 19, 1963.³⁵ This summary presented the total goals divided into sub-group areas and then divided into the savings that each military department and defense agency would achieve in that area.

Cost reduction plans and goals were now refined enough to produce results. The policies, guidance, definitions and requirements that had been promulgated verbally or by memorandum needed to be formalized. The next step was the issuance of instructions to formalize the program.

³³Secretary of the Navy memorandum for all Assistant Secretaries of the Navy and Chiefs of Bureaus and Offices, Subject: Cost Reduction Program, October 18, 1962, p. 1.

³⁴Memorandum for the Record: Number 17, October 26, 1962, Report on DOD Cost Reduction Steering Committee meeting (in the files of the Navy Cost Reduction Group), p. 2.

³⁵U.S., Department of the Navy, Secretary of the Navy Instruction, 5220.6, February 20, 1963, enclosure 5.

CHAPTER IV

FORMAL DEFENSE COST REDUCTION PROGRAM

Traditionally, the formal installation of a new program into the military commences with the issuance of formal instructions defining the program and the rules under which it will be administered. After preliminary planning the Department of Defense Cost Reduction Program was formally established with instructions. Discussion of those implementing instructions will be limited to the additional guidance, definition, procedures and reports not previously mentioned. Program goals and procedures were further refined as experience was gained in prosecuting cost reduction efforts.

The formal Department of Defense Cost Reduction Program was launched with three instructions that culminated the efforts of the Steering Committee's action on their three basic tasks of (1) establishing cost reduction areas and goals, (2) devising a reporting system and (3) planning a publicity-communications system for the program.¹ These instructions provided uniform, central direction for implementing the cost reduction program in the individual

¹Assistant Secretary of Defense (Installation and Logistics) memorandum to Altizer, September 14, 1962, op. cit., pp. 1-2.

departments.

Directive for Implementation

The subject of the first directive, issued February 1, 1963, was the "Department of Defense Cost Reduction Program."² This directive outlined the purpose, applicability, organization and responsibilities, policies, classification and reporting of savings, implementation and effective date of the program for the Defense Department. It tied together all former instructions on cost reduction. The high points of the directive are briefly covered in the following paragraphs.

The secretaries of the military departments were given direct responsibility for achieving program success. Fiscal Year 1961 or June 30, 1961 were established as base dates against, or from, which goals or progress would be measured. Savings generated by cost reduction efforts were to be the result of the application of new or intensified management practices and actions affecting logistic functions and activities. To qualify as savings, the reduction had to be the type that could be measured and documented in terms of quantity, unit price and dollar value, as well as being subject to verification. All funding actions resulting from cost reduction actions were to be reflected in reprogramming of the defense program packages and the Five

²U.S., Department of Defense, Department of Defense Directive Number 5010.6, February 1, 1963. p. 1.

Year Force Structure and Financial Plan.

Savings were defined and classified as hard savings or cost avoidance savings. The instruction also specified a reporting format to be used in reporting program savings. These last two areas were amplified in detail in the second Defense Department instruction covering reporting.

The directive was effective immediately and required departments and agencies to issue their own implementing instructions within thirty days. Secretary McNamara wanted no time lost in formally establishing the program. The directive stated that "...full implementation will be a matter of highest priority at all levels within the Department of Defense."³

Reporting Savings

The second instruction on cost reduction, issued March 7, 1963, dealt with reporting requirements.⁴ Savings were further defined and the scope of each cost reduction area was discussed in detail. Uniform procedures and formats were established for reporting current and anticipated savings.

Savings were not only defined as hard or cost avoidance savings but were further classified as budgeted, realized, anticipated, one-time or recurring savings.

³Ibid., p. 6.

⁴U.S., Department of Defense, Department of Defense Instruction, Number 7720.6, March 7, 1963, pp. 1-6.

The exact definitions are listed below.

A. Hard Savings: These are cost reductions which are reasonably measurable and which reduce the established or projected level of expenditures for a defined workload or force level for the specific function or activity concerned. These savings fall in one of the three following classification:

1. Budgeted Savings: Those actions which result in a reduction of costs or requirements for funds as stated in an approved program change or a budget submitted to the Congress. These include savings made by a Military Department or other components of the Department of Defense and reported in budgetary submission, and savings made during the Office of Secretary of Defense formulation of the budget. These result from all actions taken subsequent to the base period, which reduce the level of funds requested in the budget, and will represent amounts which would have been included in budget submissions if the savings had not been effected.
2. Realized Fund Savings: Those savings realized in the current year which have resulted in reduction of costs or requirements for which appropriations were made by the Congress, or for which funds were apportioned and made available for the function, item or activity. These savings are those which have not been previously identified as budgeted savings.
3. Anticipated Fund Savings: Those savings which are expected to materialize into fund savings during the remainder of current year, or in the budget year, but which have not been included in either budgeted savings or realized fund savings.

B. Cost Avoidance: These are cost reductions which are less susceptible of measurement than hard savings, or which cannot be directly associated with a reduction in the established or projected level of expenditures for a defined workload or force level for the specific function or activity concerned. These savings will fall into one of the following two classification:

1. Realized Cost Avoidance Savings: Those savings, other than hard savings, which have prevented an increase in costs or requirements for funds or which have produced an increase in readiness at no added cost. These result from actions taken subsequent to the base period.
 2. Anticipated Cost Avoidance Savings: Those savings which are expected to materialize into realized cost avoidance savings during the remainder of the current year, or in the budget year but have not been realized to date.
- C. One-time Savings: Those hard or cost avoidance savings which do not have carry-over benefits in fiscal years subsequent to the fiscal year in which the saving is made.
- D. Recurring Savings: Those hard or cost avoidance savings which have carry-over benefits in fiscal years subsequent to the year in which savings are made.⁵

Reports were established on a quarterly basis. All savings had to be reported, but savings below a threshold figure of \$100,000 did not require separate identification and explanation. Full explanation was required when any approved current year goal could not be met. All cost reductions were to be recorded and documented at the level where the action was performed.

The instruction also provided for positive identification of real savings and required they be integrated and reflected in the budget.

Budgeted savings, reported in the attached formats, must be specifically identified by appropriation and budget project/activity account as part of the backup data in budget submissions to the

⁵Ibid., pp. 2-3.

OASD(Comptroller). Budgeted savings and realized funds savings will be subject to verification and documentation, relatable to budget project activity accounts and where appropriate, budget submissions and identifiable in terms of unit cost, cost of specific functions or services for a defined workload, both before and after the management improvement.⁶

This instruction was also effective immediately and military departments were given forty-five days to issue supplement regulations required for implementation.

A Cost Reduction Publication

The publication "Department of Defense Cost Reduction Program" was established April 18, 1963 to achieve awareness and understanding of the program, exchange ideas on cost reduction and recognize outstanding contributions.⁷ The instruction that established the monthly cost reduction publication also provided uniform guidance for disseminating information of newsworthy events and accomplishments.⁸ Each military department was required to provide a minimum number of stories, articles and photographs for the publication on a monthly basis. The first material was due by May 20, 1963.

With these three instructions the cost reduction program was formally launched adhering to several principles of implementing cost reduction systems. The Cost Reduction

⁶Ibid., pp. 4-5.

⁷U.S. Department of Defense, Department of Defense Instruction, Number 5410.13, April 18, 1963, pp. 1-3.

⁸Ibid., p. 1.

Staff and Steering Committee established the actions required to make the program effective. Goals and reporting requirements were promulgated and a frame work for recognition and publicity established. If activity at the Office of the Secretary of Defense level had stopped at this point, the program would not have proceeded very far. However, supervision of activities and refinement of procedures continued in an effort to make the Department of Defense Cost Reduction Program more effective and further integrate it with other financial management activities. Defense Department actions subsequent to the implementing instructions will be briefly covered.

Audit: March 19, 1963

The services were advised by the Defense Comptroller of the establishment of a comprehensive audit of cost reduction goals and reported results.⁹ Several members of the defense audit staff were assigned full time to this responsibility. Adequate documentation and verification of cost reduction efforts were required prior to presenting them to Congress, the public and reflected them in future budgets.

The accounting and audit portion of defense under Mr. Borth concentrated its main effort on the cost reduction

⁹Assistant Secretary of Defense (Installation and Logistics) memorandum for the Secretary of Defense, Subject: Cost Reduction Progress Report, April 15, 1963, p. 1.

program in 1963.¹⁰ The three sections of defense audit: Contract Audit Policy, Internal Audit Policy and Inspection and Audit Division have all been involved. Their overall aim was to attain uniformity in the audit branches of the services and coordinate all audit so that the Department of Defense could speak with one voice.¹¹

Raise the Goal: May 17, 1963

Revaluation of cost reduction goals lead the Secretary of Defense to increase the monetary goal of the program. The departments and agencies were advised that "...our new objective for the cost reduction program is to achieve an annual rate of savings of \$4 billion."¹² At the same time the Secretary of Defense added two new cost reduction areas: (1) packaging, preserving and packing and (2) use of contract technicians.¹³

First Annual Cost Reduction Progress Report
to the President: July 8, 1963

This memorandum report summarized the efforts toward cost reduction within the Department of Defense. The

¹⁰"Comptroller," Armed Forces Management, November 1963, p. 66.

¹¹Ibid.

¹²Robert S. McNamara, Secretary of Defense memorandum for the Secretary of the Navy, Subject: Revaluation of Goals for the Department of Defense Cost Reduction Program, May 17, 1963, p. 1.

¹³Ibid.

highlights of the report were expressed in these phrases:

1. Savings in excess of \$1 billion were actually realized during FY 1963, compared with our estimate of \$750 million last July.
2. The actions now planned for FY 1964 and 1965 will bring the estimated annual savings, to be realized by FY 1967, to almost \$4 billion, compared with the \$3 billion estimated last July. Let me note that these savings have not in any way been achieved at a sacrifice of national security.¹⁴

Major contributions to national security, as well as efforts toward cost reduction, were reviewed to stress the last point.

Revision of Cost Reduction Reporting Instructions:
January 20, 1964

The first year of the program brought to light the need for further refinement. More specific instructions were required to standardize reporting, auditing and the measurement of savings. Defense Instruction 7720.6 was revised using early program experience to further describe program objectives, provide a more complete list of definitions and clarified the rules for reporting, documentation and measurement of savings.¹⁵

The revised program objectives, achieving a rate of savings of \$4 billion per year by fiscal year 1967, were to be realized by employing the following managerial techniques.

¹⁴Robert S. McNamara, Secretary of Defense memorandum for the President, Subject: Department of Defense Cost Reduction Program -- First Annual Progress Report, July 8, 1963, p. 1.

¹⁵U.S., Department of Defense, Department of Defense Instruction Number 7720.6, January 20, 1964, pp. 1-8.

(1) The top priority emphasis placed on the program by the Secretary of Defense, Service Secretaries and Military Chiefs; (2) The establishment of specific quantitative goals for each cost reduction area by fiscal year, by DOD Components, and within DOD Components as appropriate; (3) The formal reporting of performance against these goals on a regular basis; and (4) The independent audit and validation of savings, goals and other data reported.¹⁶

The reporting of budgeted savings was integrated with the normal defense budget estimates system. This procedure meant that hard savings which reflected changes in the budget would also be reported in accordance with instructions from the Defense Comptroller.¹⁷

The appropriate techniques of measuring savings in the various cost reduction areas were defined and subdivided under three basic types of savings. These types of savings were:

1. Individual one-time actions which contribute continuing cost reductions qualifying as meeting the FY 1967 objective.
2. Continuing actions which increase the percentage rates of performance, or which decrease funding (apportionment) level compared to the base period.
3. Aggregation of individual actions each year which may or may not recur in a future year.¹⁸

Thus, the Department of Defense Cost Reduction Program has become a formal five year program with the

¹⁶Ibid., p. 2.

¹⁷U.S., Department of Defense, Department of Defense Instruction, Number 7110.1, October 19, 1961.

¹⁸Department of Defense Instruction, Number 7720.6, January 20, 1964, op. cit., pp. 8-9.

objectives of reducing procurement and logistic costs by \$4 billion per year through improved management practices. Specific quantitative cost reduction goals have been established for each of the principal areas of logistics management. Selected goals were then established for each military department and defense agency so that each key logistic manager knew exactly what was expected of them.¹⁹

The savings were to be achieved in three basic ways:

1. Buy only what is needed to achieve balanced readiness.
2. Buy at the lowest sound price.
3. Reducing operating costs through integration and standardization.²⁰

¹⁹Hearings, Department of Defense Appropriations for 1964, Part I, Secretary of Defense, op. cit., p. 197.

²⁰McNamara memorandum for the President, July 5, 1962, op. cit., p. 1.

CHAPTER V

NAVY IMPLEMENTATION OF COST REDUCTION

The Navy, as well as other services, was informed of the forthcoming cost reduction program from its inception. A concerted effort has been made by the Navy since September 1962 to implement the plans and goals established by the Steering Committee and Sub-Group Committees. Navy support for the program and its organization of personnel and activities to participate in the program occurred prior to the defense directives establishing the program. Further program refinements came with the formal Defense Department and Navy instructions that defined the cost reduction effort. A reporting and audit system and a publicity campaign completed the program. The cost reduction program became a continuing effort to plan savings, meet and refine goals, report and audit results and publicize achievements.

Early Navy Participation

The Navy made a principal contribution at the industrial symposium on cost reduction in June 1961, which was the first milestone toward a defense program. Vice Admiral George F. Beardsley, Chief of Naval Material, delivered an address on "Current Programs in the Department

of Defense to Reduce the Cost of Defense." His speech highlighted the use of increased competition and improved purchasing techniques in defense contracting and the programs to improve contract administration.¹ Vice Admiral Beardsley was later designated as the Navy's coordinator for the Cost Reduction Program.²

The Secretary of Defense's request of September 14, 1962 for cost reduction planning and action resulted in the appointment of Milton E. Jones as the Navy member of the Cost Reduction Steering Committee.³ The Navy organized and pursued cost reduction through Mr. Jones and those Navy representatives that were later appointed to the Sub-Groups and the Navy Cost Reduction Program Group. These cost reduction leaders were supported in their efforts by the top executives in the Navy. The Secretary of the Navy backed the program in writing and briefed all top level Navy, civilian and military officials on program objectives in October 1962.⁴ Secretary Korth's support of the program was expressed in his memorandum:

I expect each of you to give this program your full and enthusiastic personal support, and to insure

¹George F. Beardsley, VADM, "Current Programs in the Department of Defense to Reduce the Cost of Defense," Address to NSIA Symposium, June 15, 1961, pp. 1-6.

²Secretary of the Navy Instruction, 5220.6,
February 20, 1963, op. cit., p. 2.

³Ibid.

⁴Secretary of the Navy memorandum for Assistant Secretaries of the Navy and Chiefs of Bureaus and Offices, Subject: Cost Reduction Program, October 18, 1962, pp. 1-2.

that all personnel under your administration or command are thoroughly familiar with the program. They should be encouraged to think and act in terms of achieving cost reduction without impairing the effectiveness of our Navy. As the program develops, I shall advise you further of actions which have been or must be taken to assure its success.⁵

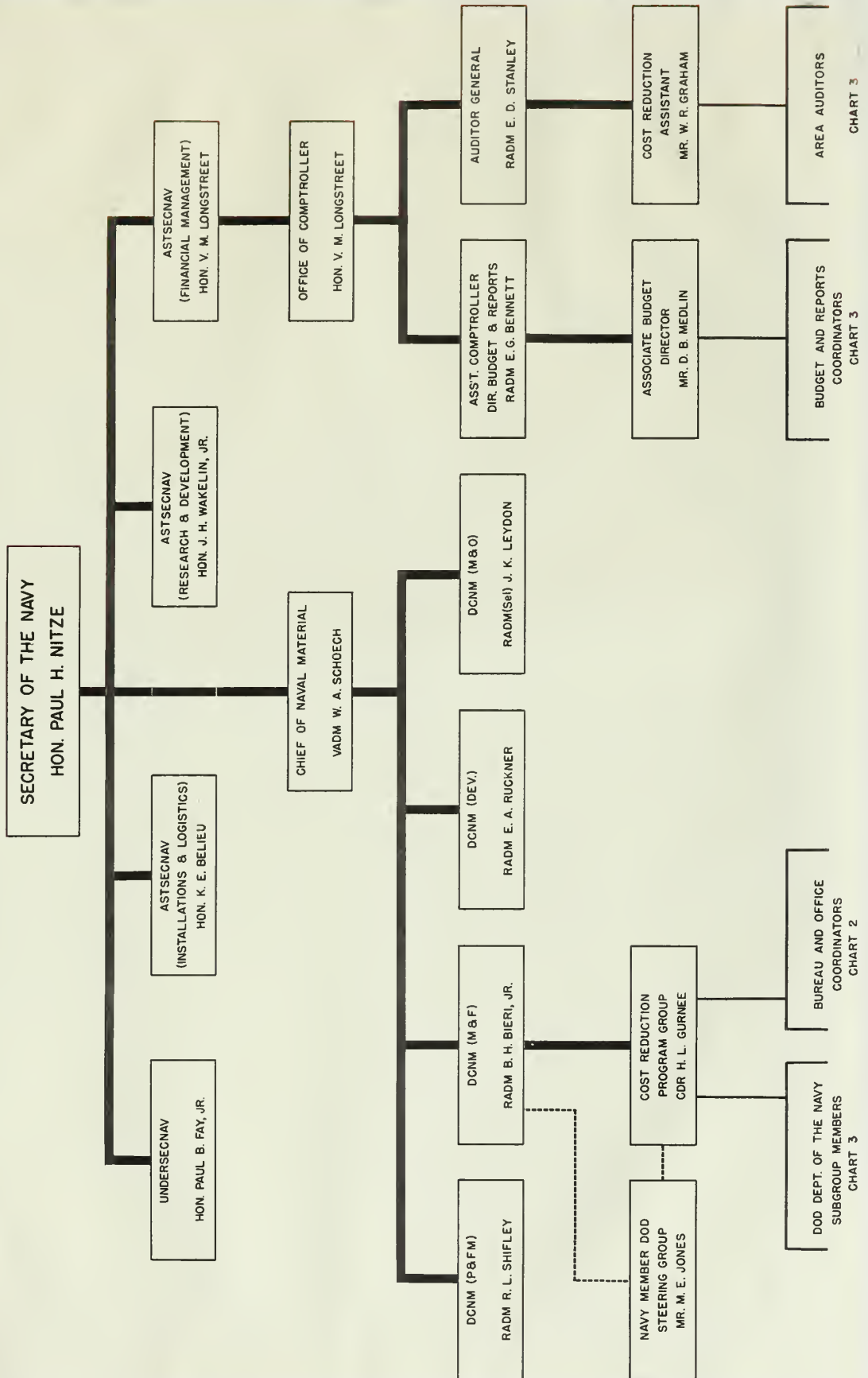
Steps were taken in October 1962 to establish an internal Navy organization to execute of the cost reduction program. The Chief of Naval Material requested that the bureaus and offices appoint contact personnel within their organizations.⁶ The internal cost reduction structure followed the normal organizational lines of the Navy as well as the functional cost reduction areas of the program. Since October 1962, the cost reduction organization has grown and become as finalized as is possible in any organization. The official Department of the Navy Cost Reduction Program organizations as of December 10, 1963 are presented in Charts II, III and IV. Chart II, page 65, traces the structure from the Secretary of the Navy to the Cost Reduction Program Group. Bureau and office coordinators that correspond to the Navy organization are shown in Chart III, page 66. Chart IV, page 67, is the structure of sub-groups that cut across bureau and office boundries and depicts the flow of savings information through the Auditor General of the Navy. It is

⁵Ibid., p. 2.

⁶Chief of Naval Material, Official Letter to the Chiefs of Navy Bureaus and Offices, Subject: Request for Appointment of Organizational Contacts for Department of Defense Cost Reduction Program, October 29, 1962.

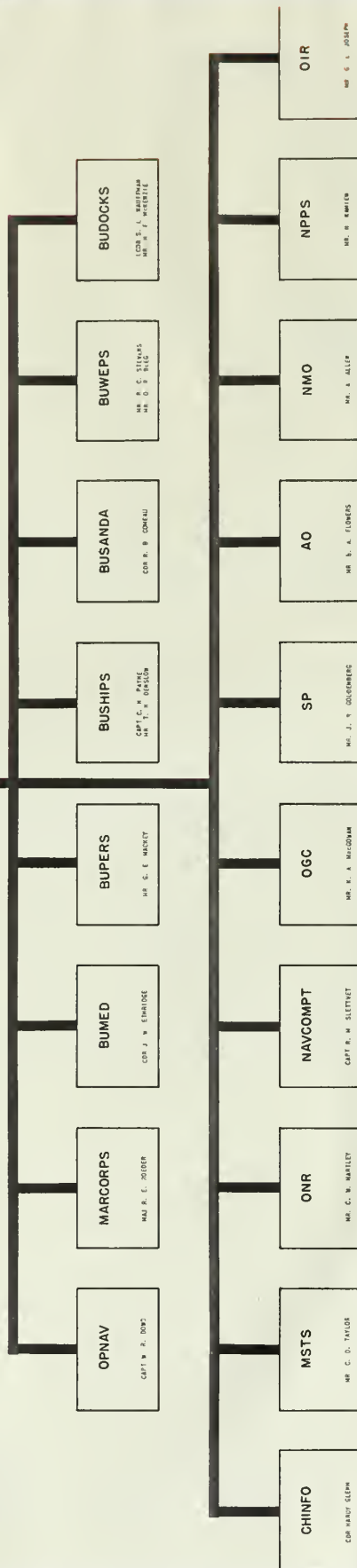
DEPARTMENT OF THE NAVY COST REDUCTION PROGRAM

CHART II



DEPARTMENT OF THE NAVY COST REDUCTION PROGRAM COORDINATORS

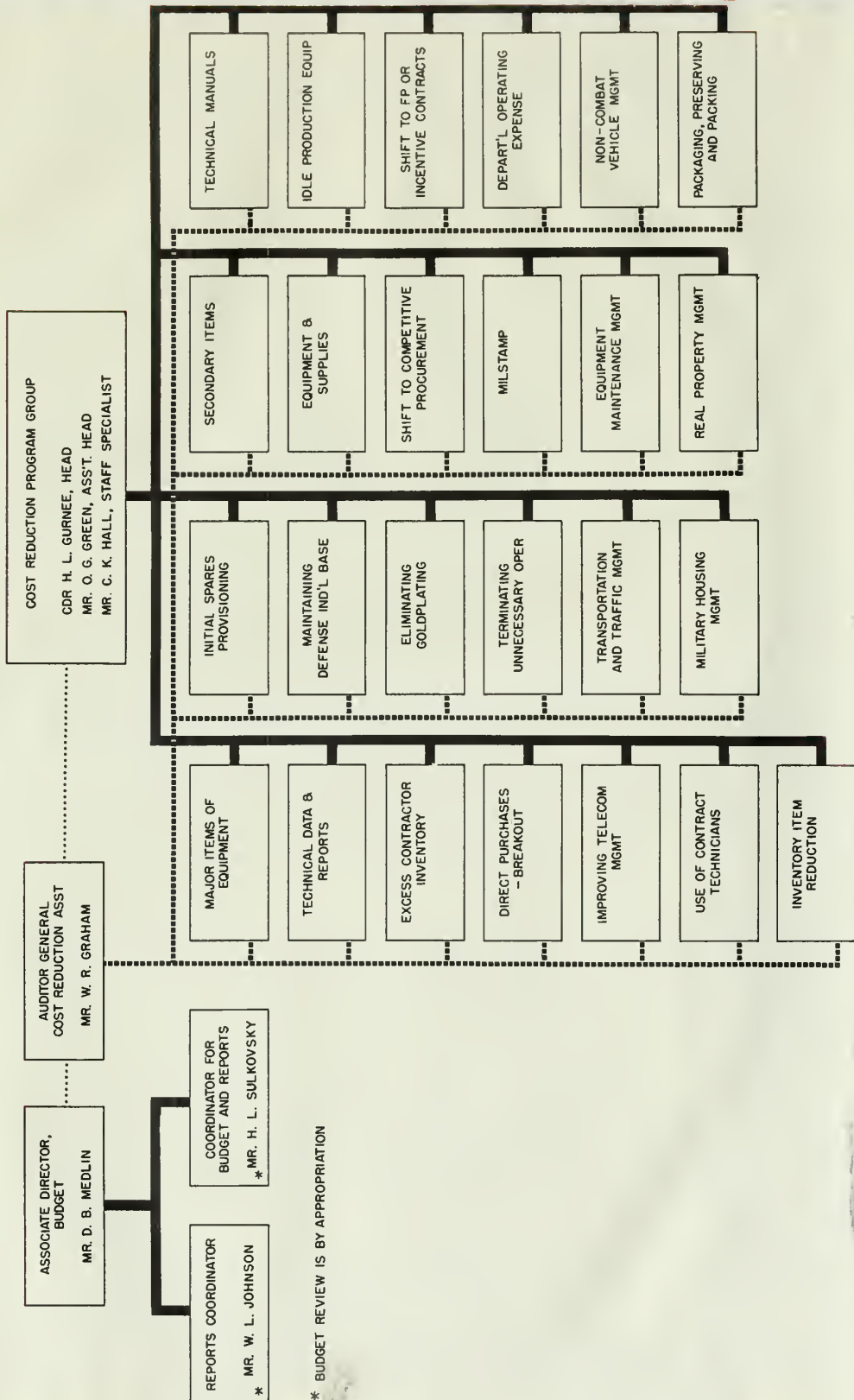
COST REDUCTION PROGRAM GROUP	
CDR. H. L. DOWNE, NADP CHIEF, COST REDUCTION PROGRAM GROUP	MR. D. R. GIBSON, NADP CHIEF, COST REDUCTION PROGRAM GROUP
MR. D. R. GIBSON, NADP CHIEF, COST REDUCTION PROGRAM GROUP	MR. C. R. HALL, NADP SPECIALIST



DEPARTMENT OF THE NAVY COST REDUCTION PROGRAM

CHART IV

MEMBERS OF DOD SUBGROUPS AND ASSIGNED AUDIT AND BUDGET PERSONNEL



* BUDGET REVIEW IS BY APPROPRIATION

noted that the cost reduction structure was established both vertically along Navy organizational lines and horizontally along cost reduction area lines. A third dimension could have been added for the sub-group members that served on the Defense Department Sub-Group Committees. This multi directed structure with its dual flow of information for reporting and audit will be further discussed in Chapter VI.

The Navy cost reduction organization grew steadily and Navy efforts and cost reduction activities increased after November 1962. For instance, the Bureau of Supplies and Accounts issued notice 4200 on November 14, 1962 requesting "...aggressive action be taken to further increase competition and reduce CPFF contracts, wherever possible, for increased savings."⁷ Navy participation in the program was virtually complete with the submission of the first quarter fiscal year 1963 cost reduction report.⁸

Formal Implementation

Although there was considerable Navy activity toward cost reduction in late 1962, the tempo increased substantially after the Defense Department instructions formalizing the program. It appeared that earlier implementation would have been fruitless for the Navy because there was no assurance

⁷ U.S., Department of the Navy, Bureau of Supplies and Accounts Notice 4200, November 14, 1962, p. 2.

⁸ Chief of Naval Material Letter Report to Department of Defense, Subject: 1st Quarter FY 1963 Cost Reduction Report, December 4, 1962.

that the Defense Department program would follow the Navy's version. However, the Navy's early planning and organization allowed prompt action to be taken as soon as the Defense Department issued instructions to implement the cost reduction program.

The formal organization and procedures for participating in the cost reduction program within the Navy were promulgated February 20, 1963.⁹ The Navy instruction encompassed the Department of Defense Directive of February 1 and specified additional responsibilities and organization within the Navy. Secretary of the Navy Korth's desire for complete support of the program was expressed in the instruction.

All management levels within the Department of the Navy are directed to give full and enthusiastic support to the DOD Cost Reduction Program and to ensure that all personnel are fully indoctrinated as to the necessity for achieving the maximum cost reduction possible without impairing Navy effectiveness.¹⁰

Secretary Korth also advised the top level Navy executives by separate memorandum of the high priority of the program and their responsibilities. In the memorandum he stated:

This is a program of the highest priority. Mr. McNamara will watch our programs closely. I look to you to provide the impetus in your area of responsibility necessary to make this program an

⁹Secretary of the Navy Instruction 5220.6, February 20, 1963, op. cit., p. 3.

¹⁰Ibid.

all-hands effort and thereby to assure its success.¹¹

In similar fashion, the next two Navy instructions closely followed the defense instruction of the same respective subjects. Secretary of the Navy Instruction 5220.7 of April 23, 1963 promulgated the Department of Defense instruction on reporting requirements within the Navy. In addition to defense procedures, the Auditor General of the Navy was assigned the responsibility for audit review and examination of program goals.¹²

Navy guidance and minimum responsibilities for submitting material for the monthly publication "DOD Cost Reduction Program" were contained in Secretary of the Navy Instruction 5220.8 of May 8, 1963. A Navy Program Publication Coordinator was assigned to the Navy Cost Reduction Program Group to organize the publicity effort.¹³

Continued Efforts

The essential steps in implementation of the cost reduction program were complete. Only the hardest part remained: the continuous operation, expansion and refinement of cost reduction efforts.

¹¹Secretary of the Navy memorandum for Under and Assistant Secretaries of the Navy and Chiefs of Bureaus and Offices, Subject: Department of Defense Cost Reduction Program, February 20, 1963, p. 1.

¹²U.S., Department of the Navy, Secretary of the Navy Instruction 5220.7, April 23, 1963, p. 2.

¹³U.S., Department of the Navy, Secretary of the Navy Instruction 5220.8, May 8, 1963, p. 2.

The impetus given the cost reduction program by the Secretary of the Navy rippled down the line. All Flag Officers were advised of the program by the Chief of Naval Operations in his "Notes to Flag Officers" periodical, and Vice Admiral Beardsley provided them with background information and copies of all pertinent instructions on cost reduction.¹⁴ Bureau Chiefs also publicized the program in local publications to inform personnel of the program and to urge participation. For example, Rear Admiral Crumpacker gave strong backing to the program in his "Message from the Chief..." that appeared on page two of the April 1963 issue of the Newsletter magazine. Similar examples, too numerous to document, are found in almost every Navy news media during 1963.

The Navy Cost Reduction Program Group assumed the major task of coordinating the department's cost reduction efforts and establishing the program in the lower levels of the Navy. Navy goals, reports and publicity were controlled through this group. In an effort to further develop the cost reduction program at Navy District logistic activities, the Navy Cost Reduction Program Group developed a cost reduction briefing team. The briefing team started visiting Naval Districts and field activities in January 1964 to answer questions on cost reduction and promulgate current

¹⁴George F. Beardsley, Chief of Naval Material, memorandum for Flag Officers of the Navy, Subject: Department of Defense Cost Reduction Program, May 24, 1962, p. 1.

program information.¹⁵ This extra effort to personally present the program, its goals and procedures to the field exemplifies the Navy's support for the program and their desire to make the program effective.

Cost reduction was a reality. The program was in operation and for the most part had been implemented in accord with the accepted principles listed in Chapter I. So far, this paper has presented the Department of Defense Cost Reduction Program from the top down without regard for problems. There were problems and questions about many areas of the program. Some of these problems will be highlighted in the next chapter.

¹⁵Interview with Mr. O. M. Green, Assistant Head, Navy Cost Reduction Program Group, January 23, 1964.

CHAPTER VI

PROBLEMS AND IMPLICATIONS OF COST REDUCTION

The formal cost reduction program has been fairly successful in its first year of operation, but it is still being refined and has some problems. Secretary McNamara recognized this in his testimony on the Department of Defense Cost Reduction Program before Congress:

I am sure that the logistic management program, which I have outlined here this morning, will not prove to be the final word. But I am equally sure that this program will correct many deficiencies of long standing and result in savings of several billion dollars per year.¹

Indeed, the final word had not been found for all questions. Growing pains were found in many diverse areas of the program. Interpretation of program principles and objectives produced some of the problems. Conflict resulted from the fact that civilian and military personnel could not be given the same incentive rewards. The cost reduction publication has not developed as planned. Cost reduction costs money and the program has resulted in a large cross meshed organization. Political pressures have also exerted an indirect affect on the program. Inspite of these difficulties there has been

¹Impact of Military Supply and Services Activities on the Economy, op. cit., p. 35.

a wide acceptance of the program and its integration with other defense financial management activities indicates that it will probably expand.

Principles and Semantics

The objectives and procedures of most programs have been subject to interpretation. Words mean different things to different people. Many factions inside and outside of defense have questioned the defense interpretation of various principles in the cost reduction program. For instance, defense was to buy only what was needed at the lowest sound price and reduce operating costs. Who was to decide what was needed and where operating costs should be reduced? What defined a sound price? Defense requirements not only encompassed the question of which weapon should be procured, but included the quality as well as the quantity of the chosen weapon. In other words, the heart of the problem was found in determining which weapon, how refined, in what quantity and at what price.

The question of who was making the determination of defenses' needs was, and still is, most controversial. Newspapers and news magazines have possibly overemphasized this issue, but the issue definitely exists. On one side there was the philosophy of strong central control with decisions made at the Secretary of Defense level based on cost-effectiveness information. The other side leaned toward

decentralization of decision making emphasizing military experience and judgment as well as cost information. Strong central control was the basis of Secretary McNamara's management of the Department of Defense and has been discussed earlier. The arguments for more decentralization are presented below.

Admiral G. W. Anderson, former Chief of Naval Operations, summarized most of the concepts that favor decentralized decisions by individual services in his August 1963 speech to the National Press Club.² He viewed overcentralization as being conducive to the abuse of power and compounding of errors. There was the fear that the monolithic-structured organization would kill imagination, stultify initiative, and completely eliminate the effectiveness of the officers who had gained wisdom and experience through military service. Admiral Anderson stated:

Experience teaches that there are no infallible judgments with respect to national security in these times of the unknown, the changing and the unexpected.

Military men have no crystal ball that can guarantee infallible decisions; but neither do scientists, analysts, engineers, businessmen, lawyers, or for that matter, computers--which must rely on human assumptions for inputs. All of us must shun reasoning based on unquestioned assumptions that become self-deceptions.³

²"Admiral Anderson's Dissent," Aviation Week and Space Technology. Editorial contains excerpts from Admiral Anderson's speech to the National Press Club. September 7, 1963, p. 21.

³Ibid.

The questions of who selects the weapons for defense and the methods used in making the decisions were foremost in Admiral Anderson's mind.

I am concerned that, in the selection of weapons, aircraft, or ships, there may not be a full appreciation of the decisiveness of a narrow edge in superior performance, both to achieve maximum safety, and to succeed to combat. I am concerned that service experience tends to be subordinated to evaluation by operations analysts on the staff of the secretary of defense or involved in contract research activities.

Military experience builds an appreciation of the truth that slight margins make big differences when the chips are down. Those who fought in the Pacific know what the narrow margin of operational superiority in the Japanese Zero fighter cost in American lives....

I am concerned...regarding a trend in the major procurement policies within the Dept. of Defense to the ultimate detriment of our military services. One proposal has been advanced which would in effect eliminate the requirement for specific recommendations by military personnel on matters such as design competitions or source selection procedures. I view any diminution of military recommendations on weapons procurement with grave alarm. Certainly the abrupt reversal of military recommendations without interim consultation, as was the case in the TFX and V/STOL contracts, is fraught at a minimum with unpleasant developments, and potentially with grave dangers. The civilian authorities exercising control, and the military, have two common objectives: First, to obtain the best weapons or weapons systems possible; second, to prevent the use of defense appropriations for anything except best performance for least cost...⁴

Obtaining the "best performance for least cost" was the same end objective of either faction. Only the method of determining the needs were different. The question has

⁴Ibid.

remained a major issue that may never be solved as:

It is impossible to choose that policy which simultaneously maximizes gain and minimizes cost, because there is no such policy.⁵

Others have questioned the methods and analysis of determining the lowest sound price. The cost reduction program featured competitive bidding for contracts as a prime method for realizing savings in this area. Secretary McNamara advised Congress he was saving 25% of each contract dollar by shifting from non-competitive bidding.⁶ The concluding statements in that Congressional hearing were:

Chairman Douglas. If you can save 25 cents on each dollar, this means that you are going to save hundreds upon hundreds of millions of dollars and get greater combat efficiency at the same time.

Secretary McNamara. That is right. I am personally a great believer in the free enterprise system. All we are doing is applying the free enterprise system to the Defense procurement.⁷

Though Congress seemed sold on the idea and were impressed with the savings, there were those that were not convinced. An Editorial in Armed Forces Management asserted that the Secretary of Defense had not proven he was saving 25 cents on every dollar converted to competitive procurement.⁸ Allegedly, the defense figures were not conclusive because

⁵Hitch and McKeen, op. cit., p. 165.

⁶Impact of Military Supply and Service Activities on the Economy, op. cit., p. 25.

⁷Ibid.

⁸C. W. Borklund, "Editorial," Armed Forces Management, January 1964, Volume 10, Number 4, p. 7.

all factors were not included in the computations. The point was that costs must be compared with other items such as maintenance studies that are significant cost factors in the life of the item.⁹ For this reason not everyone has been convinced of the reported savings of the cost reduction program. Failing to consider all factors has usually been one of the major causes of erroneous impressions. Assistant Secretary of Defense Hitch wrote that the "...most important cause of error of this sort is the exclusion of relevant costs from the computation."¹⁰ ✓

Motivation and Rewards

Cost reduction, to be effective, had to be supported and practiced by everyone. Personnel had to be motivated along cost conscious lines and provided with rewards for their economy efforts. In defense the problem was that there were both military and civilian personnel. Civilians personnel could be given rewards that could not be given to military personnel. This inequality was the major concern because it formed the basis for resentment and refusal to fully participate in the program.

The cost reduction program was founded on the premise that it would be a department wide effort concerning everyone. Each level of management from the Secretary of Defense on

⁹Ibid.

¹⁰Hitch and McKeen, op. cit., p. 169.

down have asked for and stressed individual participation.

Assistant Secretary Morris aptly summed up the need for total participation in this way:

In order for the Cost Reduction Program to be a complete success it is essential that our personnel at all levels, both civilian and military, be fully conscious of the goals to be achieved and be encouraged to take every action which will contribute to cost reduction.¹¹

The problem remained that civilian personnel could be given monetary rewards or promoted by the Incentive and Cash Awards Program, Beneficial Suggestions Program or the Federal Salary Reform Act while military personnel could not receive cash awards and could only be given recognition. The Defense Department urged that civilian personnel be given appropriate recognition and rewards using the above listed programs.¹² The Bureau of Naval Personnel took action in early 1963 to inquire into monetary awards for military personnel. They were advised by the Department of Defense that legislation to permit payment of monetary awards to military personnel for development and submission of management improvement suggestions for greater effectiveness

¹¹ Assistant Secretary of Defense (Installations and Logistics) memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Subject: Rewards for Employees Making Outstanding Contributions to the Cost Reduction Program, March 8, 1963, p. 1.

¹² Ibid.

and economy would not go to Congress in 1963.¹³ Presenting this proposal to Congress at that time was considered unfavorable, but defense would probably sponsor the legislation in the next session of Congress. The only recourse was to use the available incentive programs. All Naval activities employing civilians were urged by the Secretary of the Navy:

To make maximum use of the promotional facilities, communications channels, and recognition devices under the Navy Incentive Awards Program to publicize and promote cost reduction, to encourage employees to contribute improvement ideas towards economy, and to reward those who make outstanding contributions to the cost reduction effort.¹⁴

The inequality in rewards that could be used as incentives between civilian and military personnel has remained an unsolved problem needing action.

Publicity

Where are the monthly cost reduction publications? To date only three "DOD Cost Reduction Reports" have been printed. The organization for collecting cost reduction information, newsworthy events and accomplishments was established by Defense Department and Navy directives in April and May 1963. Since May 1963, the monthly quotas for submission of newsworthy items have continued and numerous

¹³M. E. Jones, Office of Naval Material memorandum to the Chief of the Bureau of Naval Personnel, and Chief of Industrial Relations, Subject: Monetary Incentive Awards for Military Personnel, April 23, 1963.

¹⁴U.S., Department of the Navy, Secretary of the Navy Notice 12451, June 25, 1963, p. 2.

cost reduction articles that have been forwarded to defense. It appeared that the content, type of money saving activities or the caliber of the articles have not been sensational enough or were otherwise unsatisfactory. At any rate very few have been printed. The July 1963 cost reduction publication contained the verbatim report of Secretary McNamara's first annual program report to President Kennedy of July 8, 1963.¹⁵ Efforts toward value engineering were presented in the December 1963 issue.¹⁶ From this author's point of view, the December issue was exceedingly dry and lifeless. The main problem seemed to be: How do you make an event like the changing of a \$50 fuel gauge for a \$12 dip stick in a P3A aircraft interesting to everyone in defense?¹⁷ Personnel not in aviation don't care; maintenance personnel and pilots would probably rather have the \$50 quick-reading gauge; and others may question the twelve dollar cost for the dip stick. Those small savings which represented seemingly insignificant actions form the foundation of a true cost reduction program and add up to large total department savings. Publicity for them was essential. Only the media

¹⁵Department of Defense Cost Reduction Program, (Washington: U.S. Government Print Office, July 1963), pp. 1-12.

¹⁶Department of Defense Cost Reduction Report, (Washington: The Office of the Assistant Secretary of Defense (Installations and Logistics), December 1963), pp. 1-8.

¹⁷"Navy Cuts Fuel Measurement Costs," Department of Defense Cost Reduction Report, (Washington: The Office of the Assistant Secretary of Defense (Installations and Logistics), December 1963), p. 3.

and scope of the communications was in question. The original objectives of the cost reduction program publication to exchange ideas among military departments were sound, but the results have been meager.

One possible solution of this problem was to concentrate more publicity efforts at the activity level and only attempt to publish department wide news on special events. The Navy has pursued this course of action on its own and apparently with success. Since early 1963 most of the Navy bureau and office communications media have carried articles or notes on cost reduction efforts. For example, the Bureau of Yards and Docks' publication, The Navy Civil Engineer, featured "How to Cut Transportation Costs" in its July 1963 issue. The Secretary of the Navy has also followed this line of reasoning and urged units to make maximum use of local promotional facilities and communication channels to promote the cost reduction efforts.¹⁸

It has appeared that the publicity program has not met the needs of the program and will probably require revision.

The Cost of Cost Reduction

Developing, implementing and operating a program requires money and the same could be applied to the Department of Defense Cost Reduction Program. Implementation required

¹⁸ Secretary of the Navy Notice 12451, June 25, 1963, loc. cit.

additional resources such as staffs, communications, facilities, reports and audits. Personnel had to be furnished for the Steering Committee and Sub-Group Committees as well as a full time Navy staff. The Navy bureaus have found it necessary to establish their own full time staffs to assure adequate performance in their organization. For example, the Bureau of Ships has established a cost reduction project management office employing three full time personnel and two other personnel to work part time.¹⁹ Funds under the title of cost reduction have not been available for those personnel and activities. This partially resulted because the fiscal year 1963, 1964 and 1965 budgets were presented to Congress prior to the time the program was fully implemented. Navy cost reduction funds were requested in the fiscal year 1966 budget.²⁰

Some officials have voiced concern over the costs for additional resources and the higher administrative costs required to prosecute certain cost reduction program activities.²¹ The increased use of competitive and incentive contracting was an example. A much larger administrative

¹⁹U.S., Department of the Navy, Bureau of Ships Instruction 5432.1SG4, January 16, 1964, p. 1.

²⁰Interview with Mr. O. M. Green, Assistant Head, Navy Cost Reduction Program Group, April 7, 1964.

²¹Emanuel Kintisch, Office of the Assistant Secretary of the Army memorandum for Mr. Harrell Altizer, Subject: Cost Reduction Program, October 31, 1962.

effort was required in letting bids, negotiating the contract and determining the incentives to be awarded than under cost-plus-fixed-fee contracts.²² The Secretary of Defense recognized the extra administrative expense in dealing with small business so one would assume he realized its presence in cost reduction. Secretary McNamara had this to say to the Senate Small Business Subcommittee concerning dealing with administrative costs in small business controls:

Secretary McNamara...It is more difficult and it takes more time. There is a higher cost, if you will, per dollar contracting with small business.

Senator Engle. You mean the administration of it.

Secretary McNamara. The administrative cost is higher. But I think this is one of the prices we must pay, if you will, to strengthen the economic system of this Nation and I, for one, am prepared to pay it.²³

The added expenses of cost reduction were probably recognized but the recognition has not resulted in extra funds to pursue the cost reduction effort. Each department has had to absorb the extra burden from other sources.

Cost Reduction Organization

The organization of cost reduction personnel in the Navy has formed a rather complicated matrix, as shown in Charts II, III and IV pages 65, 66 and 67, respectively.

²²Ibid.

²³U.S. Congress, Senate, Subcommittee of the Select Committee on Small Business, Hearings, The Role of Small Business in Government Procurement -- 1961, 87 Congress, 1st Session, April 25, 1963, p. 13.

Organization lines that follow department functions crossed with organization lines that follow cost reduction areas (sub-groups). The sub-group organizations crossed inbetween all military departments and the Department of Defense. The result has been a splitting of responsibility and control in three directions. These organizations are at the highest levels of the Navy where the chain of command, lines of responsibility and areas of control are well defined. The potential growth and the resulting complexities of the programs as it moves down the heirarchial chain of command could become fantastic. The implication is that the program could follow Parkinson's third law which is "...Expansion means complexity and complexity, decay; or, to put it even more plainly -- The more complex, the sooner dead."²⁴ It is axiomatic that the program must expand to all levels of management but the organization of the program at the lower levels may require simplification to facilitate participation. Otherwise the program may become so cumbersome that it would be impossible to conform to the structure which would result in the program being ignored.

Political Overtones

Defense could not help but be influenced by the political pressures of the administration and Congress. The Department of Defense Cost Reduction Program has always had

²⁴C. Northcote Parkinson, In-Laws and Outlaws, (Boston: The Riverside Press Cambridge, Houghton Mifflin Co. 1962), p. 37.

paramount economic, political implication. For instance, in an attempt to reduce operating costs the Secretary of Defense announced he proposed the closing of twenty-six U.S. bases.²⁵ Protests from the Congressmen that represented those states and districts containing these bases were immediate. As Aviation Week and Space Technology stated: "Defense Secretary Robert S. McNamara swung his economy ax harder than ever before last week and chopped off enough military operations to keep Congress in a high state of agitation through much of 1964."²⁶ It seemed to be the old proposition that cost reduction was fine, for the other guy. Yet other Congressmen and Congressional Committees have supported the cost reduction effort.

Analyzing the manner in which the cost reduction program developed points to implicit political pressure. The most obvious was the desire to present a picture of an economy minded administration. President Johnson's economy theme was the latest example:

I pledge that the expenditure of your government will be administered with the utmost thrift and frugality...I will insist that the government get a dollar's value for a dollar spent."²⁷

²⁵"Cheaper Defense: Some See \$5 Billion Cut in Military Outlays by '68," The Wall Street Journal, December 13, 1963, p. 20.

²⁶"Washington Roundup" Aviation Week and Space Technology, December 16, 1963, p. 29.

²⁷Message to the Congress, Address of the President of the United States, November 27, 1963, op. cit., p. 3.

These political pressures will always be with the cost reduction program. They are part of the system that must be understood and considered in cost reduction activities.

Future Implications of Cost Reduction

The Department of Defense Cost Reduction Program is probably here to stay even though the Defense Department experiences a change of top management every few years.²⁸ The first reason is that its record of achievement has been exceptional which has won the approval of Congress.²⁹ Even Congressmen that have been very critical of defense activities have been impressed by cost reduction achievements. A partial transcript of an Armed Services Committee hearing follows:

Mr. Hebert. May I say something there, Mr. Chairman? I think it incumbent upon me to say this. The Secretary well knows since he has been in office and his association with me that I am very short on compliments and very long on criticism...But I want to say to you, Mr. Secretary, that this has been a fight that seems to be culminating in success after some 12 years...

We fought for exactly everything that you have put into action today. You will find that these recommendations have been made through the years by the Armed Services Committee, implemented by legislation, about 4 years ago, but I will say to you that of all the Secretaries of Defense -- and I have served here under all of them, and I have very fond of many and critical of many -- but you are the very first Secretary of Defense who has put

²⁸Hearings, Department of Defense Appropriations for 1964, Part I, Secretary of Defense, op. cit., p. 242.

²⁹Katherine Johnsen, "New Bomber Funds Win Early Approval," Aviation Week and Space Technology, February 24, 1964, p. 26.

the words of the Congress and the recommendations of this committee into action.

And no matter how many disagreements I may have with you, they wash out and vanish when this presentation is made here today. I compliment you, you are indeed a real good Secretary of Defense in your field.

The Chairman [Mr. Vinson]. The Secretary put them in operation and gave his handiwork to accomplishing them...and I want the Congress to know it, I want the country to know it, that this great organization which is spending \$52 billion of the³⁰ taxpayers money is being run on a business basis.

No doubt Congressional Committees will pressure for cost reduction regardless of who occupies the position of Secretary of Defense. Another aspect that adds permanency to the program is its integration with other financial management functions. The organization, its integrated reporting and audit system and the utilization of cost reduction information in contracting, budgeting and for certain program controls provides a stable foundation for the future. A prognosis would call for further strengthening of the program objectives rather than reduced emphasis. President Johnson's policies of utmost thrift and frugality also adds new vigor to the program.

As previously emphasized, the present cost reduction program is directed at the logistics area. Once the program is firmly established in this area it could easily be expanded

³⁰U. S. Congress, House, Committee on Armed Services, Hearings, Military Posture and H. R. 9637, 88th Congress, 2nd Session, January 29, 1964, p. 7106.

to the operating forces. President Kennedy's general guidance for the program to operate this force at the lowest possible cost is all inclusive.³¹ This approach would be harder to administer so as not to impair our national security posture, but it has possibilities. For instance, the operating commanding officer's responsibility is full and complete.³²

The Commander of an organization or unit is thus its controlling head. He is responsible to his proper superior for results -- for everything his command does or fails to do, collectively and individually.³³

In the commanding officer we have the center of responsibility, control and leadership which are the essentials of any cost reduction effort. However, even though responsibilities are complete the commanding officer is not evaluated on everything his unit does or spends. One example would be the difference in the way that a command reports and is held accountable for expenditures from the Navy Stock Accounts as opposed to Appropriation Purchases Accounts. Each command is held rigidly accountable for expenditures from the Navy Stock Account and as a result

³¹Kennedy, op. cit., p. 1.

³²U. S., Department of the Navy, United States Navy Regulations, 1948, (Washington: U.S. Government Printing Office, 1948; Change 12, July 23, 1963), Article 0701, p. 81.

³³Command and Staff Principles, Report from the Command and General Staff School, (Fort Leavenworth, Kansas: The Command and General Staff School Press, 1937), p. 8.

these funds are programmed to the last penny. In contrast, the command can use the Appropriations Purchases Account without prior request or direct post reporting to the immediate superior. The Appropriations Purchases Accounts are like a free charge account which often accrue more expenditures than the Navy Stock Accounts that are tightly controlled. This facet adds complications. Expansion of the program would require changes in control and utilization of resources. The subject would probably be very controversial.

All the problems, questions and implications of the cost reduction program have not been defined. The main idea was to identify some of the questionable areas that will probably receive further consideration as the program continues. The limitation of the paper precludes a complete discussion of these problems.

CHAPTER VII

CONCLUSIONS

Military strength depends on national economic strength and financial stability. While the economy and the United States dollar must be strong to support the burden of defense, the military must be cost conscious for the sake of effectiveness itself. Indiscriminate spending cannot produce the best allocation of resources or the best weapon systems. National economic and military interests are closely interdependent. The cost of national defense has created a national cost consciousness. This cost consciousness has been reflected in Presidential and Congressional pressure on defense to economize.

The cost reduction program that has developed is not a panacea for all defense management ills, and it is not without problems. Judging the absolute success or failure of the Department of Defense Cost Reduction Program is impossible because there are few references for comparison. There are no other agencies as large as the Department of Defense and there are few universally accepted principles that are considered essential for a successful cost reduction program. Indeed, one of the most valid conclusions is that

there has been very little written concerning the methods of implementing cost reduction programs. Analyzing the literature that is available suggested that the techniques of cost reduction can be condensed into the six principles of leadership, integrated financial management, responsibilities and goals, team effort, incentives and communications, a progress and control report system. Development of the cost reduction program in Defense Department utilized all the above principles with emphasis on leadership. Presidents Kennedy and Johnson, Secretary of Defense McNamara and the service secretaries have all provided top level program support. Without the vigor and persistence of Secretary McNamara the program would not have been established.

The Department of Defense Cost Reduction Program is another financial management tool designed to increase the effectiveness and efficiency of defense activities. Since 1961 the program has evolved into a formal five year program with the objectives of reducing procurement and logistic costs by \$4 billion per year through improved management practices. It has been combined with the defense planning, programming and budgeting activities to produce an integrated system of financial management. Specific quantitative goals have been set in each principal logistics area. Selected goals have been established for military departments and defense agencies so that individual logistics managers know exactly what is expected of them. Savings are achieved by (1) buying only

what is needed for balanced readiness, (2) buying at the lowest sound price and (3) reducing operating costs through integration and standardization.

Concentrating the program in the areas of procurement and logistics, where 70% of the defense budget is spent, provided a good opportunity for initial success. Sufficient progress has been achieved to warrant raising the over all monetary savings goal from \$3 billion to \$4 billion per year and it has won the support of the Military and Appropriations Committees in Congress. On the other side of the ledger, some individual Congressmen protect bases being closed in their states. Industry is directly affected by the new procurement and contracting procedures and is being pressured to institute their own cost reduction programs. Questions have arisen as to who should determine the needs of defense and the definition of what is a sound price.

Although these problems are manifest, the cost reduction organization is growing and spreading to successively lower management levels in each military department. For example, the Navy is using a special briefing team in an effort to make the cost reduction program more effective in Naval District logistic activities. Some of the growing pains attached to the reporting, audit and communications systems are being overcome with experience. Cost reduction for Defense is a reality and seems to be expanding.

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